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

Dept. of Finance
DOF: Core Book 15

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THEME: C1

Effectiveness of the ECOFIN and Domestic Standing Group (DSG) (Central Bank, Financial Regulator and Department of Finance)

LINE OF INQUIRY: C1a

Inter-departmental contact and the Memorandum of Understandings with other EU states on the issue of banking

deposits with a maturity of post-September 2010[10]. While the guarantees have provided some relief to banks, they have not allowed them to restore their access to term market funding. The ELG Scheme has been prolonged to 31 December 2011 for all liabilities under the Scheme, subject to continuing EU Commission state aid approval at six-monthly intervals.

14. **The government also took action to strengthen banks' capital.** Given banks' difficulties to find a private solution to their capital needs, the government provided additional capital in cash or through promissory notes[11] to five domestic institutions, Irish Life and Permanent being the exception. A second measure the government took with a view to providing impaired assets relief to banks was the establishment of the National Asset Management Agency (NAMA, see Box 1). In total, some €46 billion (29% of GDP) has been injected in domestic banks over the period 2009-2010 (see Table 2). This amount does not include additional recapitalisations which will be identified under the EU/ECB/IMF Programme and injected over its course.

Table 2: Capital injections into Irish banks during the crisis (as of 28 January 2011)

Anglo Irish Bank ***(Nationalised in January 2009)***	**Total**: **€29.3bn** (18 1/3 % of GDP), including o €4 bn (June 2009) o €8.3 bn in form of a promissory note (March 2010), increased to 10.3 bn (May 2010). o €8.6 bn through a promissory note (notified June 2010, approved by the Commission on 10 August). o €6.4bn (of which €1.5bn already approved in August 2010) through a promissory note (December 2010),
Allied Irish Bank (AIB)	**Total: €7.2bn** (4½% of GDP), including o €3.5 bn (2¼% of GDP) in preference shares, via the National Pension Reserve Fund (NPRF) (February 2009) (*As part of the capital injection approved by the Commission in December 2010, all preference shares were converted into ordinary shares to increase the equity in the bank*) o €3.7bn cash investment by the NPRF in equity (December 2010)
Bank of Ireland (BoI)	**Total: €3.5 bn** (2¼% of GDP) in preference shares, via the NPRF (February 2009) of which €1.7 billion were converted into equity as part of BoI's capital raise in April 2010
Irish Nationwide Building Society	**Total: €5.4bn** (3½% of GDP), including o €0.1bn through special investment shares (March 2010) o €2.6bn in form of a promissory note (March 2010) o €2.7bn in form of a promissory note (December 2010)
EBS Building Society	**Total: €0.9bn** (½% of GDP) o €0.1bn through special investment shares (March 2010) o €0.25bn in form of a promissory note (June 2010) o €0.525bn in form of special investment shares (December 2010)
TOTAL	**€46.3bn (29% of GDP)**

Note: In addition, covered institutions benefit from the *bank guarantees* granted by the Irish authorities and have *transferred impaired property-related assets* to the bad bank "NAMA".
Source: Commission services

[10] The liabilities covered include: all deposits (to the extent not covered by deposit guarantee schemes in the State (other than the Credit Institutions Financial Support Scheme) or any other jurisdiction); senior unsecured certificates of deposit; senior unsecured commercial paper; other senior unsecured bonds and notes. In addition, a blanket guarantee will apply to all relevant deposits incurred or rolled-over by a participating institution from the time such participating institution avails of a guarantee under the ELG Scheme for the first time, regardless of type, nature or the identity of the depositor.

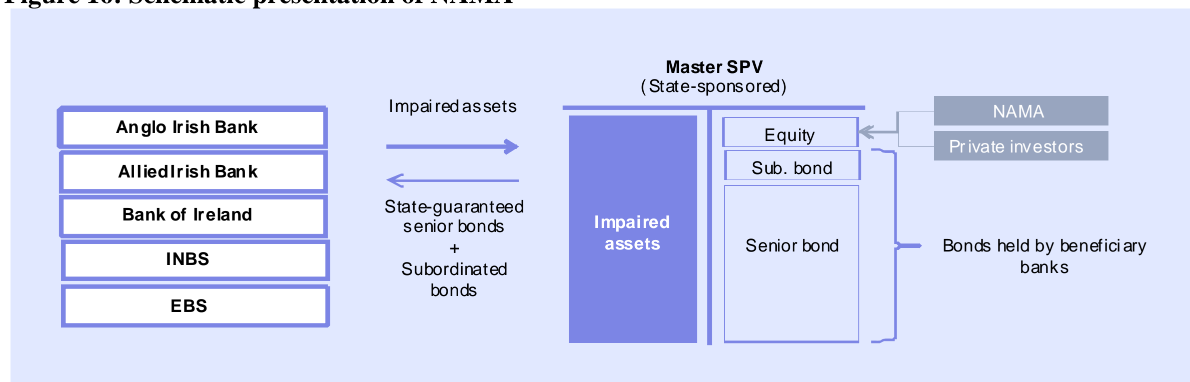
[11] Debt securities issued by the Irish State which qualify as core Tier 1 capital for the purpose of the calculation of Irish banks' regulatory capital adequacy ratio. The nominal amount of these securities is not disbursed immediately but over a 14 year period. The holder of these securities is also entitled to receive a coupon from the Irish State.

Box 1: The National Asset Management Agency (NAMA)

In December 2009, the Irish authorities established the National Asset Management Agency (NAMA), in order to arrange and supervise the purchase (as initially estimated) of approximately €82.5 billion worth of land, development property and associated commercial loans (together with associated derivatives). There are five financial institutions participating in the scheme: Anglo Irish Bank, Allied Irish Bank, Bank of Ireland, Irish National Building Society, and Educational Building Society. The minimum threshold for assets to be transferred to NAMA was initially set to €5 million for AIB, Anglo Irish Bank and Bank of Ireland. This threshold was raised to €20 million for AIB and Bank of Ireland in September 2010.. However, the minimum threshold will be removed for BoI and AIB as envisaged by the EU/ECB/IMF financial assistance programme.

NAMA is not directly involved in acquiring impaired assets and issuing bonds (see Figure 16) In order to achieve its objectives, NAMA established a special purpose vehicle (SPV), which is responsible for the purchase, management and disposal of loan assets from participating institutions and financing such purchases through the issuance of debt securities. The SPV is owned jointly by private investors (51%) and NAMA (49%). The purchase price of assets is paid through the issuance by the SPV of State-guaranteed senior debt securities (essentially IOUs) for 95% of the purchase price and the issuance of (non State-guaranteed) subordinated debt securities for 5%. The issued securities are held by the participating credit institutions pro rata their share in the assets transferred to NAMA. Table 3 presents a breakdown of assets transfers to NAMA by institution. The State-guaranteed debt securities could then be used by the participating credit institutions as collateral to receive financing from the European Central Bank, helping to improve the liquidity position of these banks.

Figure 16: Schematic presentation of NAMA



Source: Commission services

This institutional set-up implies that while NAMA is classified as part of the government, the SPV (as a company in which NAMA holds only a minority stake) is not.

The first two tranches of assets were respectively transferred in May and in August 2010, representing a total amount of respectively €15.4 and €11.9 billion. The assets were transferred to NAMA with an average haircut of respectively 50.2% and 55.7%. In September 2010, the Irish authorities announced that the remaining (NAMA eligible) assets (amounting to €46 billion) would be transferred in a single tranche to NAMA by the end of 2010 / early 2011. As of mid-January 2011, €71.3 billion had been transferred with an average discount of 58%. The transfer of the remaining €3.7 billion was expected to be completed by Q1 2011.

Table 3: Estimated NAMA Transfers (as at 20 January 2010)

	AIB	BoI	Anglo	INBS	EBS	Total
Loans > Eur 20 mn						
Loan Nominal (Eur bn)	18.5	9.4	34.0	8.5	0.8	71.3
Consideration (Eur bn)	8.5	5.5	13.0	3.0	0.3	30.3
Discount	54%	42%	62%	64%	60%	58%
Loss	10.0	3.9	21.0	5.5	0.5	41.0
Loans < Eur 20 mn (Expected) *						
Loan Nominal (Eur bn)	4.40	2.10				6.50
Consideration (Eur bn)	1.94	1.26		Not applicable		3.20
Discount	56%	40%				51%
Loss	2.46	0.84				3.30

(* Initial information as of September 2010)

Source: Commission services

Council Logo

COUNCIL OF THE EUROPEAN UNION

Brussels, 5 April 2001

6168/01

LIMITE

PV/CONS 5
ECOFIN 31

DRAFT MINUTES[1]

Subject :	**2329th** meeting of the Council (**ECONOMIC AND FINANCIAL QUESTIONS**), held in Brussels on 12 February 2001

[1] Information relating to the final adoption of Council acts which may be released to the public is contained in Addendum 1 to these minutes.

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1. **Adoption of the agenda**
5819/01 OJ/CONS 4 ECOFIN 24

The Council adopted the above-mentioned agenda.

2. **Approval of the list of "A" items**
5820/01 PTS A 4

The Council approved the "A" items as listed in doc. 5820/01 PTS A 4 **except for item 11**.

3. **Taxation : Excise duties on mineral oils**

The Council

- approved the conclusions set out in document 6172/01 FISC 22 + COR 1 (en,da,sv)

- took note of the statement of the Commission for the Council minutes as set out in the above-mentioned document.

4. **Preparation of the Stockholm European Council (23/24 March)**

- **The functioning of product and capital markets**
  = Presentation of Commission Report
  5301/01 UEM 5 ECOFIN 11 MI 5
  5300/01 UEM 4 ECOFIN 10 MI 4

The Council heard a presentation by Commissioner BOLKESTEIN of its Institution's third report of December 2000 on the functioning of product and capital markets which responds to the request formulated by the Cardiff European Council of June 1998 in the context of structural reform. This paper will be taken into consideration for the preparation of a paper on the key issues of the BEPG for the March Stockholm European Council.

- **Broad Economic Policy Guidelines**
  = Orientation debate
  5907/01 ECOFIN 25 SOC 41 MI 11
  = Contributions of other Council formations
  5797/01 MI 10 ECOFIN 23
  5617/01 SOC 28 ECOFIN 18

The Council held an orientation debate on the preparation of the Broad Economic Policy Guidelines on the basis of a note presented by the Presidency, contributions from the Internal Market and the Employment and Social Policy Councils and preparatory work done by the Economic and Financial Committee and the Economic Policy Committee.

During the debate, Ministers welcomed the Presidency's approach on the key issues paper which should be policy orientated, concise and well-focused to enable a constructive discussion on the BEPG by the European Council on both macroeconomic policies and economic reforms. Ministers expressed broad agreement on the suggestions made and on the selection of key issues to be focused upon in the next BEPG, including:

– the need to maintain macroeconomic stability, in particular to avoid procyclical budgetary policies, thereby allowing monetary conditions conducive to economic growth and continued employment creation. At the same time, the establishment of sound public finances are fundamental for dealing with the budgetary consequences of the longer-term challenge of ageing populations;

– the need to reform labour markets in order to reduce the rate of unemployment and increase labour supply;

– the need to continue to address the challenge of ageing populations and where necessary the reform of pension systems;

– the need to pursue the economic reforms in product markets in order to enhance the growth and employment potential in the EU, by promoting innovation and competitiveness while increasing the benefits to consumers;

– the need to create and integrated European financial market that will contribute importantly to stronger growth and higher employment by implementing of the various measures in the Financial Services Action Plan (FSAP) and the Risk Capital Action Plan (RCAP).

In the light of this debate, a draft of the key issues paper will be prepared in close co-operation between the Presidency, the Commission, the Secretariats of the EFC and EPC, as well as of the Council Secretariat. This draft paper will be discussed by the EFC and, in relevant parts, by the EPC at their next sessions. The paper will subsequently be forwarded to the ECOFIN Council of 12 March for adoption.

5. EMU

- **Regulation on the protection of the Euro against counterfeiting**
  = Political agreement
  6032/01 FIN 35 UEM 32 EUROPOL 15 DROIPEN 13

The Council reached a political agreement on the text of the "agreed position" as presented in doc. 6281/01.

The following statements were made to the minutes of the meeting:

Re. Article 2(b)

1. « The Council notes that in Germany and Austria the definition of "competent national authorities" in Article 2(b) of this Regulation does not concern judicial or police authorities where they act in exercise of the competence of the Member States in the application of national criminal law or the administration of justice in the Member States.»

Re. draft Council Regulation based on Article 308

2. « The Belgian and Luxembourg delegations reiterate their reservations with regard to the adoption of two Regulations on the protection of the Euro against counterfeiting, one for Member States participating in the zone, based on Article 123(4) (EC) and the other for Member States not participating in the zone, based on Article 308 (EC), as they believe that only the adoption of a Regulation based on Article 123(4) (EC) is in conformity with the provisions of the Treaty.

Nevertheless, the Belgian and Luxembourg delegations will support the solution submitted by the Presidency, provided it does not constitute a precedent for the adoption of the measures necessary for the introduction of the Euro as a single currency. »

Re. Article 2(b)

3. « The Commission welcomes the fact that the essential features of its proposal appeared in the draft Regulation which today becomes the subject of a Council agreed position.

   It expresses its disagreement, however, with Council statement No 1 on the interpretation of the expression "competent national authorities" and indicates its preference for the following version :

   > « The Council notes that the expression "competent national authorities" used in Article 2(b) concerns judicial or police authorities only in the context of the Cupertino provided for in this Regulation, which applies without affecting the competence of the Member States as regards the application of national criminal law. » ».

- **Issues related to Euro coins**
  = Conclusions

Use of EURO coins and tokens for familiarising persons suffering from sensory or intellectual disabilities

1. For the broad acceptance of the Euro the population should be in a position to recognise the Euro banknotes and coins. Training of vulnerable groups of the population is of particular importance. Ongoing action is taking place in all Member States for that purpose.

2. The ECB, in collaboration with the Commission and the European representatives of vulnerable groups, is preparing dummy banknotes designed for training. The Commission, in collaboration with the Mint Directors and the European representatives of vulnerable groups, is preparing appropriate Euro tokens. Ministers welcome these initiatives.

3. Ministers consider that the vulnerable groups should also have the possibility to familiarise themselves with the real Euro coins on the available premises of the Mints, in the Euro coin Test Centres or in other secure locations to be organised by Member States in collaboration with the representatives of vulnerable groups at national level.

Adapting the conditions for loans of EURO coins and EURO tokens to relevant industries

4. Further to the Council conclusions of 14 December 2000 with respect to the adjustment of coin-operated machines, Ministers agreed on the adaptation of the conditions for loans of Euro coins and/or tokens to the coin-operated industry. According to that agreement, Member States may reduce, to specified levels, the financial guarantees applicable to such loans as from 1 April and 1 July 2001 respectively.

6. Supplementary and Amending Budget 1/2001 concerning BSE-related measures

5956/01 FIN 33
5955/01 FIN 32
+ COR 1

The Council :

- established the draft Supplementary and Amending Budget Nº 1 for the financial year 2001 by adopting, by qualified majority, the Commission proposal as amended and recorded in document 5956/01;

- instructed the Presidency to prepare the budget documents to be sent to the European Parliament.

Following the presentation by the Commission on possible future budgetary consequences of the BSE crisis and the exchange of views within the Council on this subject, the Presidency concluded the debate by stating that :

- with reference to the conclusions which were adopted by the European Council in Nice, the Council reminds that the financial perspective must be respected, even if additional measures would be needed in connection with BSE ;

- the Council calls attention to the fact that the Commission, in accordance with the Council Regulation on budgetary discipline, should present proposals for savings, if forecasts show that financial perspective is threatened, without any delay and at the latest on the occasion of adopting the 2002 Preliminary Draft Budget.

7. **Financial Services**

- Commission communication on e-commerce
  = Presentation
  6639/01 EF 18 ECOFIN 58 CONSOM 14

The Council took note of a presentation by the Commission of its communication "E-commerce and financial services" and had a brief exchange of views. The President noted that the Financial Services Policy Group would examine the communication at its meeting on 22 February 2001 and concluded that the Council would re-examine it at a later date.

- Directive on Undertakings for Collective Investments in Transferable Securities (UCITS)
  = Political agreement
  6015/01 EF 10 ECOFIN 26 CODEC 107
  + COR 1 (fr,en)
  6016/01 EF 11 ECOFIN 27 CODEC 108

Following an exchange of views, the Council agreed to instruct the Permanent Representatives Committee to pursue its work with a view to reaching an agreement by 1 March 2001.

8. **Implementation of the Stability and Growth Pact and the Broad Economic Policy Guidelines (restricted session)**

= **Examination of the Danish updated convergence programme**
5752/01 UEM 22

The Council examined the updated convergence programme for the period 2000-2005 that Denmark had submitted and gave the opinion set out in Annex 1.

= **Examination of the Irish updated stability programme**
14625/00 UEM 33

The Council examined the updated stability programme for the period 2000-2005 that Ireland had submitted and gave the opinion set out in Annex 2.

= **Examination of the Greek updated growth and stability programme**
5128/01 UEM 1

The Council examined the updated growth and stability programme for the period 2000-2004 that Greece had submitted and gave the opinion set out in Annex 3.

= **Examination of the French updated stability programme**
5467/01 UEM 12

The Council examined the updated stability programme for the period 2002-2004 that France had submitted and gave the opinion set out in Annex 4.

= **Examination of the Italian updated stability programme**
5468/01 UEM 13

The Council examined the updated stability programme for the period 2002-2004 that Italy had submitted and gave the opinion set out in Annex 5.

= **Examination of the Austrian updated stability programme**
5416/01 UEM 11

The Council examined the updated stability programme for the period 2000-2004 that Austria had submitted and gave the opinion set out in Annex 6.

= **Examination of the United Kingdom updated convergence programme**
5753/01 UEM 23

The Council examined the updated convergence programme for the period 1999/2000 to 2005/2006 that the United Kingdom had submitted and gave the opinion set out in Annex 7.

= Commission Recommendation and Council Decision relating to Ireland

The Council adopted a Recommendation with a view to ending the inconsistency with the broad guidelines of the economic policies in Ireland in application of Article 99(4) of the Treaty establishing the European Community and agreed to make these opinions public.

9. AOB

No "Any Other Business" item was discussed during this meeting.

Concerning item 8 of the agenda

COUNCIL OPINION

On the Updated Convergence Programme of Denmark, 2000-2005

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[1], and in particular Article 9 (3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On 12 February 2001 the Council examined Denmark's updated Convergence Programme, which covers the period 2000-2005. The updated Convergence Programme foresees general government budgetary surpluses of between 2.6-2.9 % of GDP over the entire period and projects the gross consolidated debt to be reduced to 34 % of GDP in 2005. In 2000 the budget surplus turned out to be higher than earlier projected and amounted to 2.7 % of GDP, mainly due to stronger-than-expected growth.

The macroeconomic scenario assumed in the updated Programme projects real GDP growth, following an upward revision to 2.4 % in 2000, to slow down to around 1.7 % annually for 2001-2005. The Council notes that this growth scenario has been lowered from the previous update and that the Programme's assumptions on productivity rises are moderate by international comparisons. Given the robust performance of the Danish economy in recent years, in particular the buoyant investment in equipment, and the structural reforms undertaken, a somewhat stronger growth and productivity performance could be expected. Moreover, such moderate productivity rises could imply a further loss in cost competitiveness for Danish companies if relative wage increases again turn too high.

The inflation rate started to rise in 1999 and has remained relatively high in 2000. The updated Programme expects inflation to gradually decline up to 2002 as externally induced price rises should taper off and wage growth should turn slightly more moderate in the light of a weaker

[1] OJ L209, 2.8.1997

domestic demand growth. While the Council considers that the inflationary outlook, as assumed in the updated Programme, seems plausible, the Council reiterates its recommendation to the Danish government to take further actions in case of significant upward deviations[1], including budgetary ones, the more so as ERM2 membership clearly limits the monetary policy's room of manoeuvre in addressing inflationary pressures.

The Council notes with satisfaction that Denmark has continued to fulfil the convergence criterion on the long-term interest rate and that the exchange rate has remained stable vis-à-vis the Euro, also after the referendum on 28 September 2000.

Regarding government finances the Council welcomes that the Danish authorities maintain their ambition of large budgetary surpluses. As a result, Denmark continues to clearly fulfil the requirement of the Stability and Growth Pact of a budgetary position of "close to balance or in surplus" over the entire period covered by the Programme.

The budgetary consolidation strategy outlined in the previous update of the Programme is largely upheld, with a declining primary expenditure to GDP ratio and tax burden over the programme period. However, for the year 2001 the updated Programme projects a small increase in both the primary expenditure ratio and the tax burden. The Council would have preferred that the decline in both ratios was implemented without disruption.

The Council calls on all levels of general government to make efforts to limit the real increase in public consumption to the target of an annual 1 %. Furthermore, in 2001 local and regional governments are expected to raise taxes clearly above the agreements with the central government. As these agreements between the central and lower levels of government, aiming at restricting increases in public consumption and taxes, frequently have been exceeded in the past, the Council invites the Danish government, in line with the recommendations in the Broad Economic Policy Guidelines, to strengthen the institutional framework, to avoid further slippage in the future.

The Council welcomes the Danish authorities' ambition to continue to substantially lower the ratio of gross debt to GDP with a view to preparing for the forthcoming financial burden of an ageing population. The focus on longer-term sustainability issues in the updated Programme is welcomed and the Council encourages the Danish government to continue its efforts in preparing to cater for the ageing population.

The Council invites the Danish authorities to maintain the prominent place of structural reforms on the policy agenda. In particular, efforts to raise labour supply could prove necessary. The Council therefore encourages the authorities to consider lowering taxes on labour income also beyond 2002, for which a tax reduction is already planned. However, given that the Danish economy currently seems to be operating at a level slightly above its potential, such a tax cut would need to be compensated by offsetting budgetary measures in order not to add to the risk of overheating.

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[1] Council opinion of 28 February 2000 on the updated convergence programme of Denmark for the period 1999 to 2005.

Concerning item 8 of the agenda

COUNCIL OPINION

On the 2000 update of Ireland's Stability Programme, 2001-2003

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[1] , and in particular Article 5-(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On 12 February 2001 the Council examined the 2000 update of Ireland's Stability Programme, which covers the period 2001-2003.

The Council notes that the Irish economy continues to grow rapidly in 2000, with real GDP growth of 10.7% expected in the 2000 update. Employment growth in 2000 is estimated at 4.5%, with the unemployment rate declining further to 4.1% on average. Inflationary pressures have intensified. Average HICP inflation rose to -5.3% in 2000. While this upsurge in price inflation is partly due to external and temporary factors, which are expected to gradually fall out of the consumer price index, domestically-generated inflation has increased too, house price inflation remains very high and wages are rising rapidly.

[1] OJ L209, 02.08.1997

As a result of strong economic growth, the projections in the 1999 update of the Stability Programme for the improvement in the budgetary situation were exceeded by a large margin. The Council welcomes the fact that the general government balance for 2000 remains in substantial surplus, estimated to be around 4.7% of GDP, and that another sharp reduction in the general government debt ratio was achieved.

Projections for the period 2001 to 2003 show an average surplus ratio of 4.2%, with the debt ratio declining further to less than one quarter of GDP by 2003. The Council welcomes the fact that, as in the original programme and its 1999 update, Ireland fully and comfortably fulfils the Stability and Growth Pact obligations throughout the period covered. The projected general government surplus is clearly sufficient in each year to provide a safety margin against breaching the 3% of GDP reference value in the event of normal cyclical fluctuations.

The macroeconomic scenario underlying these projections assumes a gentle decline in real GDP growth and in inflation over the period. The positive output gap, after an estimated 4.5% of trend GDP in 2000, is expected to peak in 2001 at 5.4% and to gradually decline thereafter. In this context, the Council considers that the stimulatory nature of the budget for 2001 poses a considerable risk to the benign outlook in terms of growth and inflation portrayed in the 2000 update. The Council considers that this budget - the main measures of which are indirect and direct tax cuts and substantial increases in current and capital expenditure – is pro-cyclical. The Council finds that it will give a boost to demand of at least 0.5% of GDP and that its possible supply effects are likely to be small in the short term, thereby aggravating overheating and inflationary pressures and widening the positive output gap.

In particular, the strategy of inducing labour force increases through an alleviation of the direct tax burden, which was recommended in the 2000 BEPG with respect to the labour market,- may have become less effective than in the past because it took place in the context of an expansionary budgetary policy, and the tightness of the labour market could well hamper further attempts at encouraging wage moderation with direct tax cuts. Further, while indirect tax cuts have a once-and-for-all effect on the price level, they probably have no lasting effects on the rate of inflation but clearly further stimulate demand.

Given that the monetary policy is now set for the Euro area as a whole and no longer available as an instrument at national level, other policies, including budgetary policies, must be used more actively. Against this background, the Council finds that the planned contribution of fiscal policy to the macroeconomic policy mix in Ireland is inappropriate. The Council recalls that it has repeatedly urged the Irish authorities, most recently in its 2000 broad guidelines of the economic policies, to ensure economic stability by means of fiscal policy. The Council regrets that this advice was not reflected in the budget for 2001, despite developments in the course of 2000 indicating an increasing extent of overheating. The Council considers that Irish fiscal policy in 2001 is not consistent with the broad guidelines of the economic policies as regards budgetary policy. [The Council has therefore decided, together with this Opinion, to make a recommendation under Article 99(4) of the Treaty establishing the European Community with a view to ending this inconsistency.]

The Council welcomes the fact that the 2000 update addresses the issue of structural reform. In particular, the Council notes with satisfaction the progress made in the area of long-term sustainability of the public finances with the creation of a National Pensions Reserve Fund, which at end-2000 already amounts to about 6.3% of GDP. The Council also welcomes continued efforts to enhance the quality of public finances through reform of the tax/benefit system and an increased focus on capital expenditure in response to Ireland's infrastructural needs.

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Concerning item 8 of the agenda

COUNCIL OPINION

on the Stability Programme of Greece, 2000-2004

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[1], and in particular Article 5(2) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On 12 February 2001, the Council examined the first Stability Programme of Greece which covers the period 2000-2004. The stability programme was submitted by the Greek government within six months from the Council decision[2] of 19 June 2000 on the adoption by Greece of the single currency from 1 January 2001.

The stability programme is projecting robust real GDP growth rates, accelerating from 4.1% in 2000 to 5.5% in 2004, supported by high investment rates, strong exports and sustained private consumption. The Council considers the real GDP growth forecasts included in the stability programme as ambitious, at the upper range of possibilities. The programme presents also an alternative scenario projecting lower, though still robust, real GDP growth based in particular on a higher assumption for imported oil prices.

[1] OJ L 209, 2.8.1997.
[2] OJ L 167, 7.7.2000.

On the basis of the baseline macroeconomic scenario, the programme is projecting a general government surplus of 0.5% of GDP in 2001 which will rise to 2% of GDP in 2004. The programme is based on the fiscal consolidation strategy followed until now by the Greek convergence programmes, consisting in maintaining high primary surpluses supported, however, by a significant reduction in interest payments as percent of GDP, resulting from lower interest rates and a declining government debt ratio. The general government debt ratio is expected to decline by 20 percentage points of GDP, to 84.0% of GDP in 2004.

The Council considers that the projected budgetary position provide adequate safety margin against breaching the 3% of GDP deficit threshold in normal circumstances and is in conformity with the requirements of the Stability and Growth Pact. The Council commends the fiscal consolidation strategy of the programme, centred on high primary surpluses, which is essential in reducing rapidly the still very high government debt ratio and prepare for future challenges, notably the budgetary burden from ageing population. The Council considers, however, that such a strategy should be primarily based on an adequate control of primary expenditure increase through clear and binding norms with aim of reducing the current expenditure ratio.

The Council warns that under conditions of high GDP growth, according to the projections, combined with easing monetary conditions, renewed inflationary pressures may persist; the Council considers that risks of overheating of the economy need to be contained through determined support from domestic policies, mainly a tight fiscal stance, in particular through restraint on current expenditure, and by ensuring wage moderation.

The Council notes that the programme includes a number of market liberalisation measures, the setting-up of an appropriate regulatory framework and structural reforms in the labour, product and capital markets while a reform of the social security system is announced for 2001. The Council considers, however, that the ambitious growth and employment objectives of the stability programme, and future challenges, require a more determined attitude in the reform effort; the Council encourages the Greek government to accelerate the implementation of necessary reforms, in particular in the labour market and the social security system, in order to enhance the potential of the economy, strengthen its competitiveness and improve the conditions for sustainable growth and employment creation.

The Council considers that the stability programme is consistent with the Broad Economic Policy Guidelines. The Council invites the Greek authorities to pay particular attention to the need for reform of the pension system, and invites them to address the budgetary consequences of ageing in the next update of the stability programme.

Concerning item 8 of the agenda

COUNCIL OPINION

on the updated Stability Programme of France, 2002-2004

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[1], and in particular Article 5(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On 12 February 2001, the Council examined the updated Stability Programme of France which covers the period 2001-2004.

Economic growth has been robust over the past two years, broadly in line with the projections of the 1999 updated stability programme. In 2000, the French economy registered a third consecutive year of strong GDP growth with relatively low inflation. The unemployment rate continued to decline and reached 9.2% in November, down from 10.9% one year earlier. Despite this sharp fall in unemployment, wage and price developments remained very moderate. Headline inflation increased from 0.5% in 1999 to 1.7% in 2000 mainly due to higher oil prices.

[1] OJ L 209, 2.8.1997.

The Council notes that, building on a more favourable outcome than expected in 1999 and an expenditure growth slower than initially projected, the general government deficit for 2000, estimated at 1.4% of GDP, will be lower than initially expected; the government debt ratio in 2000, estimated at 58.4% of GDP, was also lower than targeted by one percentage point. The Broad Economic Policy Guidelines aim at using better than expected revenues to achieve faster reduction in the government deficit. Therefore, the Council finds that a better budgetary outcome could have been achieved in 2000, taking into account the favourable economic and public finances developments.

The budgetary projections of the updated programme are based, as in the past, on two macroeconomic scenarios, a cautious scenario, in which potential growth stays at its current level of 2.5% a year, while in the favourable scenario, potential output is estimated to gradually increase to 3% due to stronger investment and employment growth. From 2001, real GDP growth is projected to follow one of the two non-inflationary scenarios. The favourable one is presented as the economic policy target and the most likely projection. In both cases, inflation is projected to stay at a low level over the entire period.

The Council considers that the two macroeconomic scenarios of the programme provide a plausible range of values for GDP growth between 2002-2004 and that the macroeconomic performance of France in recent years indicates a probable rise in the capacity of the French economy to sustain higher non-inflationary growth than in the past, resulting from a rise in capital accumulation and a fall in structural unemployment; the Council considers, in view of the above, the macroeconomic projections of the favourable scenario as attainable.

The updated programme is projecting a general government surplus of 0.2% of GDP in 2004 under the favourable scenario and a deficit of 0.5% under the cautious one. The government debt ratio is expected to decrease from 58.4% in 2000 to 54.5% or 53% according to the alternative macroeconomic scenarios. These developments reflect mainly structural progress; however, the Council regrets that a deficit remains in 2004 under the cautious scenario. Even if the projected budgetary position provides an adequate safety margin against breaching the 3% of GDP deficit threshold in normal circumstances - in conformity with the requirements of the Stability and Growth Pact - the Council considers that the French government should seek a situation of budgetary balance in 2004 also under the cautious scenario and to advance the timing of budgetary surplus ahead of 2004 under the favourable one. This would be in line also with its recommendation on the 1999 updated stability programme.

The Council welcomes that an important tax reform is being implemented without compromising the global fiscal trend. This reform is in line with the recommendations of the Broad Economic Policy Guidelines concerning the measures aimed at improving the functioning of the labour market. The Council commends the budgetary strategy based on control of real expenditure growth; however the Council considers that a budgetary policy based on expenditure ceilings requires an

effective system to rein in spending as soon as any slippage is detected especially in the field of health care expenditure; consequently the Council invites the French government to introduce the appropriate mechanism enabling the respect of the expenditures norms. The Council notes that the increase in expenditure included in the Finance Law for 2001, 1.8% in real terms, accounts for a significant part of the norm for the cumulated increase for the period 2001 to 2003 fixed at 4% in real terms in the 1999 updated programme. Moreover the Council notes that the norm for the cumulated increase in expenditures has been revised upwards, real spending being allowed to increase by 4.5% in real terms from 2002 to 2004. In the view of the Council, a lower increase in expenditure would be desirable to allow a faster reduction in the government deficit.

The Council considers, further, that available budgetary margins should be used, as a matter of priority, in strengthening the budgetary position and preparing for future challenges, notably the budgetary burden from the ageing of population. In this respect, further progress with pension reform would be welcome.

Concerning item 8 of the agenda

COUNCIL OPINION

on the updated Stability Programme of Italy, 2002-2004

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies [1], and in particular Article 5 (3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On 12 February 2001 the Council examined Italy's updated stability programme, which covers the period 2000-2004. The Council welcomes the revision of the objectives for the general government budget balance in 2000 and beyond, as recommended in the Broad Economic Policy Guidelines. The Council notes favourably that the reduction of the debt ratio to below 100% of GDP in 2003 is confirmed in spite of the higher target in 2000 compared to the first update of the stability programme. However, considering the still high debt ratio and the future challenges to the long-term sustainability of public finances from an ageing population, the Council considers that Italy's revised fiscal targets could have been more ambitious.

[1] OJ L209, 2.8.1997.

The Council notes Italy's intention to continue the budgetary strategy outlined in the initial programme, which aims at keeping the primary surplus at a high level and reducing current expenditure as a percentage of GDP, in parallel with some easing of the tax burden. Higher than expected tax receipts are assumed to have provided backing for the tax and social security contribution cuts outlined in the programme. The primary surplus is expected to increase as a percentage of GDP, averaging 5.5% of GDP over the period. The underlying budgetary position over the programme period provides a safety margin against breaching the three percent of GDP deficit threshold in normal cyclical fluctuations, implying that Italy would continue to satisfy the requirements of the Stability and Growth Pact up to 2004.

The Council observes that there are risks that the budgetary framework outlined in the updated stability programme may not materialise as planned. The macroeconomic projections, which assume a significant acceleration in GDP growth from an annual rate of 1.4% in 1999 to over 3% in 2002-2004, may be optimistic also in the light of recent developments in the external environment; on the other hand, the assumptions on interest rates are rather conservative in light of recent developments in financial markets.

The available data do not allow at present a conclusive appraisal of the implementation of the budget in 2000. However if the general government deficit were higher than the new objective of 1.3% of GDP, Italy would not have fully complied with last year's Council opinion and with the recommendations of the June 2000 BEPG. As for 2001 and beyond, there are concerns that the increase in planned revenues, which has provided backing for the tax and social security contribution cuts, may not turn out to be fully structural and that the expenditure-reducing measures introduced with the Financial Law for 2001 could not be fully effective.

In the light of the considerations made above, the Council urges Italy to firmly commit itself to respect the programme's objectives. Primary surpluses should remain at the high levels projected in the programme. Any deviation from the planned deficit and primary surplus outcomes should be promptly addressed and corrective measures taken. This should be ensured through a tight control of current primary expenditure. The Council encourages Italy to accompany the reduction in the ratio of current primary expenditure to GDP with a more effective and more comprehensive rationalisation of public spending, aimed at improving the supply-side conditions of the economy.

Moreover, even though Italy fulfils the requirements of the Stability and Growth Pact, it should take every opportunity to improve future budgetary targets and speed up the consolidation process, in order to accelerate the reduction of the government debt ratio. The Council recommends that future decisions to reduce the tax and social security contributions burden should be matched by offsetting expenditure cuts.

In line with both its Opinion[1] on the original stability programme and its Opinion on the first updated programme[2], the Council notes that Italy has not taken further steps to address the medium-term structural challenges to public finances from pension and other age-related budgetary expenditures. The reassessment of the parameters of the pension system scheduled to take place later this year should not be postponed. The Council urges Italy to address this issue with determination. Although the Financial Law for 2001 includes a few isolated measures on pensions, the Council advocates a more comprehensive approach. The reassessment of the pension system should take place within the framework of a broader overhaul of the Italian welfare system.

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[1] OJ C68, 11.3.1999.
[2] OJ C98, 6.4.2000.

ANNEX 6

Concerning item 8 of the agenda

COUNCIL OPINION

on the updated Stability Programme of Austria, 2000-2004

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council regulation (EC) No. 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], and in particular Article 5(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On 12 February 2001 the Council examined the updated stability programme for Austria which covers the period 2000-2004.

The updated programme envisages a decline in the general government budget deficit from 1.4% of GDP in 2000 to a balanced position in 2002 and the following years. The government gross debt is expected to decrease from 61.1% of GDP to below the 60% reference value in 2002 and further to 55.3% in 2004. The Council notes with satisfaction that, in compliance with its recommendation on the previous update of the programme[2], the current programme envisages a much faster reduction of the government deficit. Moreover, the Council acknowledges that the budgetary goals are to be achieved without resorting to the one-off measures included in the previous update.

The Council notes that, in spite of higher-than-projected growth, the estimated deficit for 2000 in the current update is not lower than projected in the previous programme once originally

[1] OJ L209/1, 2.8.1997.
[2] OJ C162/1, 10.6.2000.

unbudgeted UMTS proceeds are excluded. The Council recommended in its opinion on the previous update and in the recommendations of the June 2000 BEPG that, in the event of higher growth, a better deficit outcome should be achieved. The available data do not allow at present a conclusive appraisal of the implementation of the budget in 2000. If, however, the outcome for the general government deficit were not lower than the objective of 1.7 % of GDP, Austria would not have fully complied with last year's Council opinion and the BEPG recommendations.

The deficit projections of the programme are based on a macro-economic scenario expecting output growth to decline from its cyclical peak of 3.5% in 2000 to 2.3 % in 2003 and resume to 2.5% in 2004, amounting to an annual average growth of 2.6% over the forecast period.
The Council considers that the expected growth is feasible in view of the presently good supply and demand conditions for the Austrian economy.

The underlying budgetary position implicit in the deficit goals is in line with the requirements of the Stability and Growth Pact from 2001 onwards, i.e. they provide Austrian government finances with a large-enough safety margin to withstand a normal cyclical downturn without breaching the 3 % of GDP reference value for the deficit. The Council notes with satisfaction that, in accordance with its recommendations, the Stability and Growth Pact is now respected earlier, which is appropriate in view of the currently favourable economic conditions.

However, the Council notes that in the initial years of the programme the deficit reduction relies heavily on revenue side measures. As a consequence, the already high tax burden in Austria rises further in 2001, thereby more than offsetting the effects of the income tax reform 2000. The Council, therefore, invites the Austrian government to consider measures which permit a significant decline in the tax burden, especially on labour, while preserving the budgetary adjustment path.

The Council considers that, to achieve a balanced budget by 2002, a strict budgetary implementation at all levels of government is crucial. This seems essential in view of uncertainties regarding the savings estimates of the public administration and pension reforms. At the level of the Bundesländer the expenditure cuts necessary to achieve the surpluses required by the national stability pact largely remain to be defined.

The Council acknowledges that, by 2003, more than half of the total envisaged consolidation originates from expenditure savings. This requires that achievements in budgetary consolidation are locked in and budgetary discipline is maintained in the years 2003 and beyond. Any additional spending or further revenue reductions, including those envisaged in the programme, should be made strictly contingent on compensatory expenditure cuts. In light of the medium- and longer-term challenges to public finances, not least due to population ageing, and the need to render government finances more conducive to investment and growth the Council considers that fiscal adjustment needs to be continued with determination.

The Council acknowledges ongoing structural reforms of the Austrian economy in line with the Broad Economic Policy Guidelines. The recent reform of early retirement is particularly welcome. However, the Council encourages the Austrian government to continue its reform efforts in order to better achieve and safeguard sustainable government finances in the medium and longer term, namely in the pension system and the health care sector. The Council invites the authorities to provide more information on this issue in the next update of the programme. The Council also encourages the Austrian government to continue determinedly with the reforms of product and capital markets, with a view to enhancing competition, fostering the provision of risk capital and improving entrepreneurial dynamism and corporate governance.

ANNEX 7

Concerning item 8 of the agenda

COUNCIL OPINION

On the updated convergence programme for the United Kingdom 1999-00 to 2005-06

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council regulation (EC) No. 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[1] , and in particular Article 9 (3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On 12 February 2001 the Council examined the updated Convergence programme of the United Kingdom which covers the period 1999-00 to 2005-06. The programme envisages a government surplus of 1.1% of GDP in 2000-01, a smaller surplus in 2001-02, balance in 2002-03 and deficits around 1% of GDP in the three following years to 2005-06. The Council considers it appropriate that the programme stresses the securing of macro-economic stability supported by sound monetary and fiscal policies and continued structural reform.

The programme is built upon a macroeconomic framework showing a return of GDP growth from 3% in 2000 to close to trend – put at 2½% - thereafter, which the Council considers to be realistic if cautious. Moreover, the projections in the programme for the public finances are, for reasons of caution, based on a lower assumption for trend growth - namely 2¼%.

[1] OJ L209, 2.8.1997

With respect to inflation and interest rates, the United Kingdom continues to fulfil the convergence criterion with some margin. The Council notes that the monetary framework of inflation targeting, with operational responsibility for interest rate changes given to the Bank of England, has been an important condition for securing low inflation expectations. The Council notes that under the current policy framework, the programme projects the UK inflation target to be achieved over the programme period.

The United Kingdom has fulfilled the convergence criterion on the long-term interest rate for some time. This helps confirm the credibility given to the UK's stability oriented framework for macro-economic policy. It notes that while there are signs of reduced exchange rate volatility, it cannot be concluded that this policy framework has delivered a stable exchange rate. Therefore the Council recommends that the United Kingdom continue with the stability oriented policies with a view to securing exchange rate stability which, in turn, should help re-enforce a stable economic environment.

The general government finances are in 2000/01, 2001/02 and 2002/03 close to balance in underlying terms thus fulfilling the requirements of the Stability and Growth Pact. However, the Council notes that a persistent deficit of 1% of GDP emerges in the latter years of the plan; larger than the deficits of around ½% of GDP in the two final years of the previous update. This would not be in line with the prescription of "close to balance or surplus" contained in the Stability and Growth Pact. The Council acknowledges that this emerges in the projections as a result of the use of a very cautious trend growth assumption of 2.25 % per annum and as a consequence of increased government investment as a share of GDP within the expenditure totals. Should trend growth be higher, as expected, compliance with the BEPG will require more ambitious budgetary outcomes. While the specific recommendation to the UK in the BEPG advised the UK to pursue a policy of substantially raising the ratio of government fixed investment to GDP, it also recommended to do so within the context of firm control of government expenditure, thereby keeping the underlying position of government finances broadly unchanged. Therefore, the Council encourages the government to be alive to any deterioration in the public finances that would take them away from the terms of the Stability and Growth Pact and, if necessary, to take remedial action.

The Council notes that the government gross debt ratio in the United Kingdom remains below 60% of GDP and is expected to fall to 40% in 2000-01. The Council welcomes the envisaged further reduction of the gross debt ratio to 35% of GDP by 2004-05.

The Council welcomes the structural reforms included in the programme. It notes, with approval, that the progress on economic reforms should help to raise productivity levels to those of competitors and secure further improvements in the labour market.

The Council notes that the programme provides both long-term projections of public finances and a description of policies that could be addressed to minimize the impact of ageing, and welcomes the sustainable position which is projected.

COUNCIL OF THE EUROPEAN UNION

Brussels, 14 November 2007

13661/07

LIMITE

PV/CONS 49
ECOFIN 387

DRAFT MINUTES [1]

Subject:	**2822nd** meeting of the Council of the European Union (**ECONOMIC and FINANCIAL AFFAIRS)**, held in Luxembourg on 9 October 2007

[1] Information relating to the final adoption of Council acts which may be released to the public is contained in Addendum 1 to these minutes.

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ANNEX 8

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1. **Adoption of the agenda**
   13228/07 OJ/CONS 49 ECOFIN 356

The Council adopted the above-mentioned agenda with the addition of the item "Stabilisation and Association Agreement with Montenegro" under Any Other Business.

2. **Approval of the list of "A" items**
   13229/07 PTS A 41

The Council adopted the "A " Items listed in 13229/07, excepting item 6.

The documents in item 3 should read as follows:

Item 3: 13072/07 FIN 422 PE-L 99
+ ADD 1

Information relating to items 9, 15, 16 and 17 is set out in Addendum 1 to these minutes.

3. **Implementation of the Stability and Growth Pact *(restricted session)***

– **Excessive deficit procedure**

– Adoption of Council Decision
= **United Kingdom**
13067/07 ECOFIN 360 UEM 150
13293/07 ECOFIN 363 UEM 152
+ REV 1
+ COR 1

Having decided unanimously, on grounds of urgency, to consider a legal text that was not available in all the languages provided for in the Council's linguistic regime, the Council adopted a Decision abrogating Decision 2006/125/EC on the existence of an excessive deficit in the United Kingdom, as set out in 13293/1/07 REV 1 + COR 1, in accordance with Article 104(12) of the Treaty establishing the European Community.

– Adoption of Council Recommendation
= **Czech Republic**
13064/07 ECOFIN 359 UEM 149
13312/1/07 REV 1 ECOFIN 364 UEM 153

Having decided unanimously, on grounds of urgency, to consider a legal text that was not available in all the languages provided for in the Council's linguistic regime, the Council adopted a Recommendation to the Czech Republic with a view to bringing an end to the situation of an excessive government deficit, as set out in 13312/1/07 REV 1 in accordance with Article 104(7) of the Treaty establishing the European Community.

4. Public Finances in EMU: Improving the effectiveness of the preventive arm of the Stability and Growth Pact

– Council conclusions
13337/07 ECOFIN 369 UEM 154

The Council adopted conclusions on improving the effectiveness of the preventive arm of the Stability and Growth Pact, as set out in 13337/07.

It also took note of information from the Chairman of the Economic and Financial Committee concerning agreement in his committee to introduce some technical amendments to the data tables set out in Annex 2 of the Code of Conduct relating to specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes, as approved by the Council on 11 October 2005.

5. **Quality of Public Finances: The modernisation of public administration and its impact on expenditure control and competitiveness**

– Council conclusions

13316/07 ECOFIN 366 COMPET 263
13317/07 ECOFIN 367 COMPET 264

The Council adopted the conclusions as set out in 13316/07.

6. **Developments on the economic and financial situation**

– Follow-up of the informal meeting in Porto

The Council held an exchange of views on the economic situation and financial stability, on the basis of a report from the Economic and Financial Committee (see Annex) and further to discussion by ministers at an informal meeting in Porto on 14 and 15 September.

The Council agreed on the attached work programme, which runs until the end of 2008, aimed at reviewing, along with the EU's international partners, how to further improve transparency, the valuation process and risk management in financial markets.

7. **Better Regulation: Improving competitiveness**

– Council conclusions

13286/1/07 REV 1 ECOFIN 361 COMPET 259

The Council adopted the conclusions as set out in 13286/1/07 REV 1.

8. **Flexicurity: Economic aspects**

– Council conclusions

13287/07 ECOFIN 362 SOC 341
10255/07 SOC 241 ECOFIN 312

The Council adopted the conclusions as set out in 13287/07.

9. **Dialogues with Third Countries: Economic, financial and regulatory aspects**
– Information from the Commission and exchange of views

The Council was briefed by the Commission on dialogue with the EU's main international partners as regards macroeconomic, financial and regulatory issues.

It held an exchange of views on developments in strategic dialogues aimed at enhancing convergence, cooperation and mutual understanding between international partners and contributing to the facilitation of market access and to promoting macroeconomic stability.

The Presidency suggested that the Council be regularly updated on these dialogues.

10. **Financial Services**

a) Clearing and Settlement
– Council conclusions
13313/07 EF 57 ECOFIN 365

The Council adopted the conclusions set out in 13313/07 EF 57 ECOFIN 365.

b) EU arrangements for Financial Stability
– Council conclusions
13359/1/07 REV 1 EF 58 ECOFIN 370

The Council adopted conclusions as set out in 13359/2/07 REV 2 EF 58 ECOFIN 370.

11. Any Other Business

– **Global Navigation Satellite System (GALILEO): Financing aspects**

13237/07 FIN 434 CADREFIN 45 TRANS 285 MAR 70 AVIATION 161 RECH 250
+ REV 1 (en, fr, de)

The Council held a broad exchange of views on the financing aspects of GALILEO and reiterated the importance of the project while noting the various positions taken; it was decided to hold a full discussion at the next Council session, being understood that the Presidency would at a later stage spell out how the file is to be handled procedurally, in the light of developments.

– **Information regarding forthcoming Stabilisation and Association Agreement with Montenegro**

The President informed colleagues of the state of preparations regarding the planned signing on 15 October of a Stabilisation and Association Agreement and an Interim Agreement on trade and trade-related matters with the Republic of Montenegro, notably regarding a declaration on the use of the euro to be entered into the Council minutes on the occasion of the approval and signing of the agreements (as set out in 13831/1/07 REV 1 and 13833/1/07 REV 1).

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ANNEX

Re: Item 6 on the agenda – Developments on the economic and financial situation

REPORT FROM THE ECONOMIC AND FINANCIAL COMMITTEE

Financial markets situation

– Key issues and follow-up actions –

1. RECENT DEVELOPMENTS

1. Financial markets have been in turmoil since August, amid a sharp decline in investors' appetite for credit risk. The turmoil was triggered by financial losses due to defaults in the US market for sub-prime (i.e. low credit-quality) mortgages. These losses have been transmitted rapidly across the global financial system via the markets for complex financial instruments. The opacity of these instruments, combined with credit risk dispersion, has made it difficult to identify the exact size and location of losses, thereby undermining investor confidence in financial markets more generally. The functioning of money markets has been particularly disrupted, requiring considerable interventions by major central banks into the interbank markets to restore orderly conditions by providing liquidity.

2. Most recent evidence suggests that conditions in financial markets have partially stabilised, but that the situation remains uncertain. The evolution and duration of the current market turbulence and the resulting impact on credit conditions will depend to a large extent on the eventual scale and distribution of financial losses. For this reason also, it is difficult to quantify the likely macroeconomic impact of the turmoil. The performance of the global economy was strong in the period ahead of the turmoil and this growth momentum is likely to be sustained through the remainder of 2007, also for the Euro area and EU economies. However, downside risks have increased and some softening in economic growth in the EU would seem likely in 2008, reflecting both tighter financing conditions and the likelihood of a slowdown in the US economy which would be only partly offset by continued buoyancy in the larger emerging economies.

3. The possibility of financial turbulence, linked to a re-pricing of risk towards more sustainable levels in some markets where valuations appeared to have become stretched, had been identified at an earlier stage. Nevertheless, the specific features of the turbulence and its transmission mechanism were not anticipated and revealed a number of weaknesses, in particular in the markets for complex financial products, which have become rapidly illiquid in conditions of stress. This is the first serious market turmoil since the rapid expansion in the use of these products. The situation continues to unfold and the Ministers of Finance, Governors and Supervisory Authorities are carefully monitoring developments in financial markets and the economy as a whole.

4. In this context, it is still too early to reach final conclusions on possible regulatory and/or supervisory responses but, a preliminary set of key issues to be further analysed and addressed has been identified by the EFC. Some of these issues are already under review by the Commission and supervisory authorities at the EU and global level. Other issues may come to the fore that need to be reviewed. The ongoing financial turbulence adds urgency to this work.

2. KEY ISSUES TO BE ADDRESSED

5. Financial innovation contributes to the efficiency of financial markets by facilitating the spreading of risk, but it also creates new challenges for regulatory and supervisory authorities. Overall, the EU regulatory-supervisory framework and cross-border cooperation in respect of exchange of information have functioned relatively well. Still, an important feature of the recent turbulence has been the lack of information, which raises issues of transparency in the markets for complex financial products as well as questions about how these products are valued, monitored and treated within the framework for prudential regulation and supervision.

- **Enhance transparency for investors, markets and regulators**

6. The absence of accurate and timely information on exposures to credit risk has been a key factor in the generalised loss of investor confidence in financial markets since August. Questions about the adequacy of transparency have been raised in several respects, including: (i) information provided to individual investors and the broader market by special purpose vehicles (SPVs), i.e. conduits and Structured Investment Vehicles (SIVs) involved in the securitisation process; (ii) bank disclosure of securitisation operations and exposures to SIVs, (iii) complexity in the structuring and measurement of risk in structured finance products as well as difficulties in valuating these products; and (iv) opacity in the functioning of markets for complex financial instruments. Supervisors and regulators need to examine how and where progress can be made in improving transparency, including in arrangements for information exchange among themselves.

- **Improve valuation standards, including of illiquid assets**

7. The ultimate responsibility for the valuation and accounting treatment of assets lies with institutions holding the assets. However, supervisors, accounting standard setters and other relevant authorities also play an important role from a prudential perspective. More work is needed on standards to ensure reliable valuation of assets, particularly of those assets where markets are potentially illiquid in time of stress, while ensuring compatibility with international financial reporting standards.

- **Reinforce the prudential framework, risk management and supervision**

8. In recent years, financial markets have evolved both in terms of size and sophistication and it is essential that the framework for prudential regulation, supervision and financial stability arrangements keeps pace with these developments. In this context, the EU Finance Ministers have since 2003 been developing the arrangements for financial stability in the EU. On 9 October, the ECOFIN Council agreed on common principles and further actions to enhance the effectiveness of financial stability arrangements and the ability of authorities to respond jointly in serious disturbances in EU financial markets. In Spring 2008, a new Memorandum of Understanding (MoU) will be signed

between Heads of Competent Banking Supervisory Authorities, Central Banks Governors and Finance Ministers in the EU. The Commission and Member States will also work toward enhancing the availability of the tools, necessary in preserving financial stability in Member States and in ensuring their functioning across-border between relevant parties. The possible enhancement of Deposit Guarantee Schemes within the EU to ensure their effectiveness in stemming a loss of confidence in the financial system also needs to be examined.

9. The Lamfalussy framework will be reviewed in December 2007. This review will provide an opportunity to take stock of progress made and to identify further steps that would ensure that the EU framework for prudential supervision evolves in line with market developments.

10. The Capital Requirements Directive, which implements the Basel 2 framework in the EU, will fully enter into force on 1 January 2008. It will help to improve transparency, particularly in the context of securitisation), and will instil greater discipline in the transfer of risk from credit institutions, thus reducing the scope for regulatory arbitrage and limiting capital relief to operations where risks are effectively transferred. Nonetheless, the significance of off-balance sheet exposures, liquidity risk and reputational risk in the recent financial turbulence suggests a need to further reflect on regulation and oversight in these areas, e.g. liquidity exposures to special purpose vehicles, assessment of risk transfer, practices for liquidity management, procyclical effects of credit market developments and proper prudential treatment of credit risk embedded in structured products held for trading.

- **Improve market functioning, including rating agencies**

11. Recent events underscore the importance of a better understanding of the role of securitisation within the financial system, based on comprehensive market statistics, and of how the so-called "originate and distribute" model, where banks do not hold the loans they originate but repackage and securitize them, has impacted on the incentives structures of credit markets, in a context characterised by a shift from the more traditional retail to interbank borrowing.

12. A better insight into the incentive structures, including possible conflicts of interest and disincentives to perform proper due diligence, faced by credit originators, credit rating agencies and other market participants is required. In this context, the EU should examine the role of credit rating agencies, in particular as regards structured finance instruments, conflicts of interest, transparency of rating methods, time-lags in rating reassessments and regulatory approval processes. In addition, excessive reliance solely on credit ratings by investors without carrying out due diligence or conducting further own risk assessments as well as the transparency of rating methods in managing their risk has to be dealt with.

13. Work is being pursued on the issues mentioned (a roadmap is included in this annex) and first conclusions can be expected in spring 2008. A wide range of policy options should be considered alongside the necessary initiatives from the industry to improve transparency, risk management practices and, in adopting self-regulatory action.

3. COOPERATION AT THE GLOBAL LEVEL

14. Many of these issues must be addressed in an international context, including through the Financial Stability Forum (FSF). The EU and its Member States must play an active role in global discussions with the key partners and should work towards enhancing the efficiency and stability of international financial markets, including from the perspective of the Single European Market.

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ANNEX

ROADMAP

This roadmap identifies the preliminary set of key issues to be analysed and addressed following the recent market turbulence as well as a timeframe for final conclusions and action. The relevant EU fora (Commission, level 3 committees, FSC and ECB) are invited to carry out this analysis and draw preliminary conclusions. They should work closely with relevant international bodies such as the G10-regulators (for CEBS), IOSCO (for CESR), international accounting fora and the FSF, which is preparing a report on related issues for the April 2008 meeting of the G7. The industry should also be consulted on a number of issues.

The Commission is invited to closely follow these different work streams so as to shape its views, ensure consistency, including with its own work programme and, formulate and propose appropriate policy responses.

The various actions identified should be co-ordinated by the EFC. Following a preliminary discussion at the FSC, the Commission and the FSC are invited to report on progress to the March 2008 EFC. The EFC will report to the April 2008 Informal Ecofin, which will provide further guidance, including in respect of the preparations of the ensuing G7 meeting.

ROADMAP:

(1) Enhance transparency for investors, markets and regulators by

– Examining whether public disclosure of types and amounts of securitisation exposures, of significant individual transactions and of sponsoring of Special Purpose Vehicles' exposures by banks under Capital Requirements Framework (Basel2/CRD) is sufficient;	Mid 2008
– Where necessary, organising comprehensive, frequent relevant statistical data on credit markets, asset pricing for authorities and, where appropriate, the public.	Mid 2008

(2) Improve valuation standards by

– Agreeing on a common approach to the accounting valuation of illiquid assets; and,	Mid 2008
– Considering improvements in market valuations more generally, together with the implications for risk management practices by banks;	Mid 2008
– Examining the deployment of sound asset valuation standards in non-bank investors (e.g. asset managers, pension funds etc), particularly in relation to (potentially) illiquid assets.	September 2008

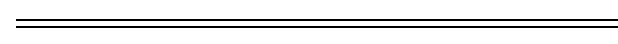
(3) Reinforce the prudential framework, risk management and supervision in the financial sector by

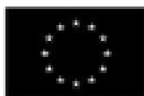
– Reviewing possible enhancements of Deposit Guarantee Schemes in the EU, including issues related to communication between authorities and depositors;	Mid 2008
– Assessing the level of risk management standards in non-bank investors (e.g. asset managers, pension funds), particularly in relation to potentially illiquid assets;	September 2008
– Examining possible enhancements of liquidity risk assessment and management by banks by taking forward the forthcoming Basel Committee recommendations, to ensure banks are well equipped to withstand stressed market conditions;	End 2008
– Examining the need for a wider concept of concentration risk, including wholesale and interbank markets, and intra-group exposures, as part of the EU Large Exposure Review;	End 2008
– Examining the Capital Requirements Framework for banks' liquidity exposures Special Purpose Vehicles to reflect lessons concerning banks', including (1) incentives to move risk off-balance sheet; (2) regulation and management of liquidity and reputational risks transferred to these vehicles; and, (3) valuation and treatment of these vehicles and forced asset buy-backs;	End 2008 (depending on G-10)

– Identifying and removing any regulatory arbitrage opportunities and examining the Capital Requirements Framework for banks' own trading book exposures, including the treatment of "warehousing" and "pipeline" risks;	End 2008 (depending on G-10)
– Considering how to improve global cooperation between supervisors, including outside the EU, taking into account the proposals to enhance cooperation and by renewing and improving crisis management tools as set out by the ECOFIN on 9 October 2007 based on EFC recommendations.	End 2008

(4) Improve market functioning, including the role of credit agencies, by

– Examining the role of credit rating agencies, in particular as regards structured finance instruments, conflicts of interest, transparency of rating methods, time-lags in rating reassessments and regulatory approval processes;	April 2008
– Examining the incentive structures in credit markets and the implications of the "originate and distribute" models of banks for credit markets;	Mid 2008
– Examining rules covering the origination and (mis-) selling of mortgage credit;	Mid 2008
– Examining the organisation of non-regulated debt markets.	Mid 2008





COUNCIL OF THE EUROPEAN UNION

Brussels, 16 November 2001 (05.12) (OR. fr)

13542/01

LIMITE

PV/CONS 61
ECOFIN 311

DRAFT MINUTES [1]

Subject : **2382nd** meeting of the Council **(Economic and Financial Questions)**, held in Brussels on 6 November 2001

[1] Information concerning the final adoption of Council acts which may be released to the public may be found in Addendum 1 to these minutes.

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1. **Adoption of the agenda**
13423/01 OJ/CONS 61 ECOFIN 307

The Council adopted the above agenda.

2. **Approval of the list of "A" items**
13422/01 PTS A 60

The Council approved the "A" items listed in 13422/01 PTS A 60.

Information relating to item 1 on the list is set out in Addendum 1 to these minutes.

3. **Report on the budgetary challenges posed by an ageing population: implications for public spending on pensions, on health care and on care of the elderly and possible indicators of the long-term sustainability of public finances**
13471/01 ECOFIN 309 SOC 413 SANTE 130

After hearing a presentation by Mr Cotis, the Chairman of the Economic Policy Committee, of the Committee's report as above and Commissioner Solbes's comments on the subject, the Council discussed the report.

On the conclusion of its discussion the Council approved the following conclusions:

"The Council endorsed the report prepared by the Economic Policy Committee on budgetary challenges posed by ageing populations. The report, established at the request of the Council, reviews projections of the impact of ageing on public expenditure on pensions, health care and long-term care for the elderly up to the year 2050, and puts forward possible indicators to examine the overall long-term sustainability of public finances on the basis of these projections.

The report identifies some key challenges stemming from the large changes in the size and composition of the population in all the Member States in the coming decades. The Council notes that, whilst caution needs to be exercised in interpreting all long-term projections, the impact of ageing on public finances would be large in terms of expenditure for pensions, health care and long term care for the elderly.

Regarding pensions, the projections made by the Economic Policy Committee show that, notwithstanding reforms during the 1990s, ageing populations could lead to a substantial increase in public expenditures of between 3 and 5 percentage points of GDP up to 2050 in most Member States, and even larger increases are projected for several. The design of public pension systems plays a crucial role in determining the scale of the budgetary impact of ageing. The Council notes that higher employment rates, especially amongst women and older workers, can help mitigate the pressure for increased spending on pensions due to ageing, but on their own cannot prevent an increase in expenditure levels.

Regarding health care, the Council notes that ageing populations could lead to an increase in public spending of around 1 to 2 percentage points of GDP over the long term up to 2050. Whilst it should be noted that the projections for public expenditure on health care and long-term care for the elderly depend to an important extent on the methodology and the assumptions used, those Member States for which projections on both health care and long-term care are available could face increases in expenditure levels over the fifty years of around 2 to 4 percentage points of GDP.

The Council underlines that in view of the expected budgetary pressures posed by ageing populations during the next decades, ensuring sustainable public finances, including by public debt reductions, is a crucial challenge that Member States must address as soon as possible. The report demonstrates that the budgetary impact of ageing will be substantial in almost all Member States.

The Council therefore notes with interest the indicators put forward by the Economic Policy Committee to assess the overall impact of ageing populations on the sustainability of public finances. These indicators first aim at verifying whether current budgetary policies are likely to ensure sustainable public finances and respect of the Stability and Growth Pact in the longer run, and secondly specify the degree of budgetary adjustment required to ensure that this goal is met. These indicators could be usefully complemented by indicators reflecting pension liabilities. The Council also acknowledges, however, that an evaluation of overall fiscal sustainability needs to take into account all types of public expenditure as well as changes in the revenue from the taxation of pensions.

On the basis of the report, the Council:

– concludes that this report provides a valuable input for the reports to be examined by the Laeken and Barcelona European Councils on pensions, health care and long-term care for the elderly. Taking due account of the principle of subsidiarity, the projections on pensions could also be used in the context of the open method of coordination in the field of pensions;

– considers that the indicators developed by the EPC to measure the sustainability of public finances in view of ageing are a valuable first step, to be developed further, and invites the EFC and the Commission in collaboration with the EPC to examine how they could be used in future assessments of stability and convergence programmes. In line with the agreement of the European Council in Göteborg, Member States' comprehensive strategies for addressing the economic and budgetary challenges posed by ageing populations should be presented in conjunction with stability and convergence programmes and be examined in the context of multilateral surveillance. The results of the work should be integrated into the Broad Economic Policy Guidelines;

– invites the EPC to repeat its common projection exercise at EU level at an interval of three to five years, and to take the necessary steps to further improve the quality and comparability of projections. The Council also invites the EPC to continue with its work programme on the economic and budgetary consequences of ageing populations".

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The Council agreed to publish the report and its conclusions on its website.

4. Report on output gap assessment methods
13402/01 ECOFIN 304 UEM 81

After hearing the introduction to the above report by the Economic Policy Committee on alternatives methods of assessing potential growth and output gaps from Mr Cotis, Chairman of the Committee, and having taken note of the progress made on the subject both at the Economic and Financial Committee and at the Commission, the Council held an exchange of views on the report.

On the conclusion of that exchange of views, the Council adopted the recommendation made to the Commission in the report that it start using the new "production function" approach in

the 2002-2003 budget surveillance exercise,in particular in the context of the implementation of the Stability and Growth Pact, in parallel with the so-called Hodrick-Prescott (HP) filter method which the Commission then used.

Commissioner Solbes said that for its part the Commission was prepared to accept that recommendation from the Council.

The Council then invited the Economic Policy Committee to continue its work to refine that method and to submit the results of that work to the Council before the end of 2002.

5. Risk capital action plan

– Commission communication
13383/01 MI 159 ECOFIN 300 SOC 406

After a Commission presentation and an exchange of views, the Council took note of the Commission communication.

6. Report on EMU statistical obligations
13388/01 UEM 79 ECOFIN 301

After hearing a presentation by Mr Åkerholm, the Chairman of the Economic and Financial Committee, of the Committee's report as above and Commissioner Solbes's comments, the Council adopted the following conclusions:

"The Council endorsed the fourth progress report by the Economic and Financial Committee on information requirements in EMU. The report examines progress on the implementation of the Action Plan on EMU Statistical Requirements (EMU Action Plan), endorsed by Ecofin Council in September 2000, as well as progress on the original report by the Monetary Committee on Information Requirements in EMU endorsed by Ecofin Council in January 1999. Ministers decided that the fourth progress report would be made public.

The Council noted that further progress has been made under the EMU Action Plan (which covered quarterly national accounts, quarterly accounts for the government sector, statistics on labour markets, short-term business statistics, and statistics on external trade). Resources now are reported to be sufficient for its implementation. The Council also noted that much remains to be done in France, Italy and Spain to achieve the targeted 80% coverage of Member States' data in euro area aggregates within the recommended deadlines. To fulfil the needs of country-by-country analysis, also several other countries, notably Greece, Ireland, Luxembourg and Portugal need to do more.

Relative to the original report by the Monetary Committee, a number of actions are still necessary. In particular further improvements must be achieved in timeliness of key indicators so that EMU Statistics get close to US standards of availability and timeliness within the next five years. That report also stressed the need for a broader statistical basis on service activities, a better balancing of priorities between speed, detail and quality of statistics, and the collection of data for rapid production of European aggregates.

The Council stresses that the quality of data on cross-border payments must be preserved. Member States affected are urged to adapt their balance of payments collection systems in line with the requirements of higher reporting thresholds and the shift of the reporting burden from banks to enterprises.

The Council, in conclusion, considers that in order to improve the statistical basis for economic and monetary policy making in EMU/EU, a number of Member States still need to increase efforts to fulfil their obligations under the EMU Action Plan. Particular attention should be devoted to the area of labour market statistics. The Council furthermore considers that in order to meet shortcomings identified in the original Monetary Committee report, a number of coordinated actions are still required by the Member States. Ministers invite the statistical offices in the Member States to take the necessary action as a matter of priority. They ask for a follow-up report for the autumn of 2002".

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The Council agreed to publish the report and its conclusions on its website.

7. Ireland: Follow-up to the recommendation of 12 February 2001

After re-examining, on the basis of the Commission report, the Recommendation it addressed to Ireland on the inconsistency of the Irish budget with the broad guidelines of economic policy, the Council adopted the following conclusions:

"The Ecofin Council examined today a report from the Commission on economic and budgetary developments in Ireland in 2001. The report was submitted by the Commission in response to an invitation contained in the Recommendation addressed by the Council to Ireland on 12 February 2001. The Recommendation, which aimed at ending the inconsistency with the broad guidelines of economic policy engendered by the Irish budget plans for 2001, urged the Irish government to take countervailing budgetary measures during the current fiscal year.

The Commission report concludes that the implementation of the budget in 2001 reflected some of the concerns underlying the Recommendation. Expenditure has been kept under control, including by decisions to offset unforeseen expenses with spending cuts elsewhere in the budget. Moreover, two measures introduced after the Recommendation, a tax-preferred savings scheme and a tax recovery scheme, go in the direction of a short-term easing of demand pressures, as requested in the Recommendation. Above all, in the assessment of the Commission, unexpected developments, which are slowing down the economy and thereby reducing inflationary pressures, mean that the inconsistency addressed in the Recommendation between the Irish budgetary plans and the goal of economic stability has lost part of its force for this year. Such developments include the agricultural crises (especially foot-and-mouth-disease), the slowdown in the United States and world economy and now the aftermath of the recent tragic events in the US. However, the Commission argues that the experience of overheating in the Irish economy justifies continued vigilance regarding the evolution of the fiscal stance. After the large decline in the general government surplus expected for this year, in both actual and structural terms, the Report concludes that further reduction in Ireland's structural fiscal surplus in 2002 should be avoided.

The ECOFIN Council takes note of the Report of the Commission and shares its main conclusions. While agreeing on the importance of taking into account the changing economic situation, the Council stresses the need for continued vigilance on the fiscal stance in Ireland given the experience of overheating. In this connection the Council notes that its recommendations have been to some extent adhered to. Taking note of the need to plan for a broadly neutral fiscal stance in Ireland, the Council considers that a budget for 2002 along these lines would provide further evidence that fiscal policy in Ireland is being directed toward stability and therefore in compliance with the Council Recommendation. The Council will assess the budgetary stance for 2002 when the forthcoming update of the Irish stability programme will be discussed".

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On the conclusion of that re-examination the President of the Council stressed that the case in point, namely the first Recommendation that the Council had addressed to a Member State on the basis of Article 99(4), could usefully serve as a precedent. Accordingly, a future Recommendation would be re-examined by the Council on the basis of a Commission report and the Council would adopt conclusions, which would be published, assessing the action the Member State had taken in response to the Recommendation.

Finally, the Council agreed to publish its conclusions on its website.

8. Towards an internal market without tax obstacles
– Commission communication
13365/01 FISC 224

The Council:

– took note of the Commission communication entitled "Towards an internal market without tax obstacles" presented by Commissioner BOLKESTEIN;

– invited the Permanent Representatives Committee, the High-Level Working Party and the Working Party on Tax Questions to examine that communication with a view to preparing for a discussion within the Council at a later stage.

9. Taxation of audiovisual and musical products

The Council noted that, where indirect taxation was concerned, the Commission was to report by the end of 2002 on the application of reduced rates. Moreover, in accordance with the Treaty and with the rules of competition, the Commission would focus its attention on the impact of the measures applied or being considered in the Member States for the development of this sector.

10. Other business

– **Debriefing on the informal European Council meeting in Ghent**

= **Presidency oral report**

In this connection, in response to an invitation addressed to the Council by the informal meeting of Heads of State and of Government in Ghent on 19 October 2001, the President of the Council stated the Presidency's intention of having the Council meeting on the Internal Market on 26 November 2001 approve a political agreement on the proposal for a Regulation of the European Parliament and of the Council on cross-border payments in euro (11440/01 EF 80 ECOFIN 224 CODEC 818).

In addition, the President of the Council stated the Presidency's intention of organising the macro-economic dialogue on 3 December 2001, to which a European Parliament delegation would be invited as an observer, and the high-level dialogue with the accession candidate countries on 4 December 2001.

Finally, the President of the Council confirmed the Presidency's intention of convening a Council meeting on Economic and Financial Question at Laeken on 14 December 2010.

07/MHG/07.

Minister

From Secretary General

<u>BRIEF FOR MINISTER FOR FINANCE, MAY 2008</u>
<u>MAIN POLICY ISSUES</u>

1. The main priorities for the Department for the future.
We outline below the main priority areas and issues which we expect to be bringing to your attention in the coming months and beyond. More detailed briefing on these and on other priorities are contained in the attached separate folder.

<u>Budget and Economic and Pensions Division: Mr. Jim O'Brien</u> (Tab 1)

Budgetary and fiscal sustainability - ***A separate note on the emerging economic and fiscal position as we currently see it is attached.***

At Budget time real GDP growth of 3% for this year, averaging 3½% over the period 2008 – 2010, was forecast. At the time, this view was slightly below the general consensus. In the Budget we identified a number of risks – weaker Irish housing activity, the strength of the euro against the dollar and sterling, persistently higher oil prices, the fear of a US recession and prolonged upheaval on the international financial markets leading to a more general credit crunch outside of the sub-prime market. In the intervening period these risks either have materialised, or are now more likely to do so. **As such our current working assumption is that GDP growth for 2008 will be around 2% and average in the range 3 - 3¼% for the period 2008 – 2011.**

At end-April taxes were €736 million below profile – 45% of this shortfall is due to the poor performance of Capital Gains Tax. While it is very early to call an end-year position, **<u>we are now factoring in a €2 billion shortfall in taxes but have not publicised this as yet</u>**.

On the expenditure side, there are emerging spending pressures – including health, education and welfare payments from higher numbers on the Live Register. For the purpose of the detailed note on the emerging economic and budgetary position an overrun of €300 million on the Live Register has been assumed.

Thus in overall terms the Budget day Exchequer deficit of €4.9 billion is now likely to be over-shot by €2 billion and the General Government Balance is likely to be around -2.2% of GDP as opposed to -0.9% forecast on Budget Day. **<u>This represents a significant worsening of the position for this year with serious consequential impacts for next year.</u>** We are currently re-assessing the implications for 2009-2011 in the context of the draft Budget Strategy Memorandum (BSM) which we would aim to put before you for consideration in the next few weeks. The BSM is usually brought to Government in early July.

Continued success into the medium and long term will depend crucially on maintaining competitiveness and budgetary stability. Bringing current public expenditure increases down to sustainable levels – low single digits – will be crucial in that context.

- **Pensions Policy**

The Green Paper on Pensions was launched last October. This has been followed by a consultation phase which lasts until the end of May 2008. The Government will then begin the process of developing a framework for dealing with pensions over the long term. This will be a sensitive issue involving a balance between sustainability and pressures to improve cover and raise pensions levels. [Public sector pension reform will be an important component of the overall approach].

- **Long term issues/ageing**

These pressures present a key challenge for the future in relation to the sustainability of the public finances which need to be taken into account in Budgetary policy in the shorter term. A separate report is being prepared by an internal group. While such long-range reports cannot predict the future, they do provide a useful overall context for policy formulation. The key findings will relate to the very significant spending implications of a rapidly growing elderly population, inexorably leading to a need for some fiscal adjustments over time to ensure long-term fiscal sustainability. That sustainability is critical to achieving both sound economic conditions and to securing social progress. This report will be submitted to you soon. Another important long-term macro-economic challenge relates to the environment and, in particular, Climate Change (see Tab 3 – SPD).

- **EU International**

The Eurogroup and Ecofin (Economic and Financial Council of Ministers) meet once a month. The next meeting is next week (Tuesday night/Wednesday). You attend this meeting accompanied by Mr O'Brien. Member States' economic and budgetary positions, the turmoil in the financial markets and the supervisory arrangements for financial institutions dominate discussion at this stage. Ireland's economic and fiscal position is expected to be discussed at the June Council. The debate on the Review of the EU Budget is expected to start in earnest later this year. This could have major implications for Ireland post-2013, in particular, in relation to the monies we receive from and have to pay in to the EU.

- **Annual Meetings of the IMF/World Bank**

The Boards of Governors of the International Monetary Fund and World Bank Group are scheduled to meet in Washington DC on 13th October 2008. As Governor for Ireland at both institutions, the Minister is invited to attend the Annual Meetings and to present a statement setting out key issues and strategic priorities for Ireland's involvement in the institutions. (Ministers do not always attend.)

- **NTMA**

The Chief Executive (Mr Michael Somers) reports direct to you on NTMA matters [Management of Debt portfolio (which now has to accommodate raising new debt) State Claims Agency, NDFA]. There is an NTMA Advisory Committee chaired by Mr David Byrne.

- **Pensions Fund**

There is a Pensions Commission chaired by Mr Paul Carty who reports to you as required, along with Michael Somers – the NTMA is the manager of the Fund.

Public Services Management and Development: Mr. Ciarán Connolly (Tab 2)

- **Pay and social partnership (Towards 2016):** *Towards 2016* is a ten-year framework social partnership agreement. The first pay agreement under *Towards 2016* expires at various dates in the private sector and at the end of September 2008 in the public service. As regards the overall framework agreement a review is to take place during 2008 of outcomes achieved in relation to the overall goals and any opportunities arising to refocus and reprioritise.

  Negotiations on the next pay agreement and the review of the broader framework began on 24 April 2008. Keeping pay increases in the public and private sectors to levels which will not further undermine our competitiveness is key. This strand will also encompass some difficult workplace issues, e.g. agency workers, union recognition. In the review of the overall framework any adjustments can only be made within existing budgetary parameters and cannot add to net overall expenditure commitments.

- There is a range of major **industrial relations issues in the health sector** which are critical for the reform of the sector. There is still a possibility of a dispute affecting nurses on pay issues but not immediately. Bringing the negotiations on the hospital consultants' contract to a conclusion is proving extremely difficult.

- The Department has responsibility for public service modernisation. Consideration of the **OECD report "Towards an Integrated Public Service"** and implementation of Government decisions arising therefrom will be a priority. Key issues arising include strengthening the citizen-focus of all public services, increased mobility and flexibility across the sectors of the public service, setting up a Senior Public Service to provide a single Public Service leadership cadre; improved governance and performance dialogue to address the current disconnects between the central civil service and the wider public service; establishing clear guidelines and criteria for establishing new agencies and for operating existing ones; developing e-*Government* to achieve a more citizen centred approach. The structures to develop and implement the Government's response to the report have to be decided.

- Continued development of 'E-Government' of the civil and wider public service is an ongoing issue.

- **Decentralisation**: The Decentralisation Implementation Group (DIG) is reviewing the position on State agencies – this part of the programme is posing particular problems. A sub-group of Secretaries General is reviewing the accommodation, management and other needs in Dublin for the nine Departments and Offices whose headquarters are relocating. On publication of the latest report of the DIG in October, 2007, it was expected that over 6,000 posts would have relocated by end-2009. The DIG are currently updating the position and early indications suggest that there are likely to be some slippages in the previous timeframes.

- **Legislation**: The Ethics in Public Office (Amendment) Bill 2007 has been passed by the Seanad. A number of Government amendments are to be proposed in the Dail. Drafting of the Ombudsman (Amendment) Bill is nearing completion.

Sectoral Policy Division: Mr. Donal McNally (Tab 3)

- The immediate objective is to ensure that Departments keep to Budgets in 2008. There are already emerging pressures on the social welfare side (up to €300 million because unemployment figures are higher than allowed for in the Budget); and in health and education.

- The next imperative is to reduce the rate of increase in current spending for 2009 to the expected weaker growth in resources. This means that given the very low growth in resources likely next year, the target for growth in current expenditure must be kept to very low single digits. This will be difficult given the expectation for ongoing improvements in social services (S/Welfare, Health, Education) and pay expectations.

- On top of this we will have to drive for efficiency in the delivery of Public Services together with value for money. Responses from Departments in relation to the efficiency drive initiated in the 2008 Budget were disappointing and this Department has prepared a draft Memorandum for Government for consideration of appropriate action which will be submitted to you shortly.

- Maintaining the level of public capital investment is important, but this will require discipline on the rest of the Budget.We need to maintain a high rate of capital spending (5% to 6% of GNP) to enable Ireland to firstly address a historical deficit and secondly to grow at higher rates over future years. The NDP (2007-2013) and Transport 21 set ambitious plans for capital investment. On the basis of current expenditure being tightly controlled, borrowing for productive capital investment can be justified in a country with very low debt/GDP ratio like Ireland.

- Further reform of the Budget process is needed in order to move to multi-annual current Budgets and to link up Departmental outputs with the resources actually provided. This will be a priority in 2009.

- We are currently aiming to meet our Kyoto targets through the policies outlined in the National Climate Change Strategy. A far more significant challenge will be to meet the targets emerging from the current discussions on EU legalisation to reduce emissions (by 20-30%) in the EU by 2020. These negotiations need to be closely monitored and will have significant economic and social implications.

<u>Taxation and Financial Services Division: Mr. Kevin Cardiff</u> (Tab 4)

- **Commission on Taxation**
  This is chaired by Frank Daly and has been asked to report by September 2009 at the latest. It has been given a wide ranging terms of reference, being charged with addressing social, economic and environmental issues. At the same time, it must put forward policies which will deliver the funds necessary to fund public services.

- **Taxation policy.**
  Development of a tax package for Budget 2009 will be a challenge in current circumstances. In the meantime, we will be starting preparations for the 2009 Finance Bill. The changeover to the new Vehicle Registration Tax system, provided for in this year's Finance Bill, will take place in July. Tax policy issues may also feature in Social Partnership and Pensions Green paper discussions but the room for manoeuvre will be very difficult in the current fiscal circumstances.

- **Income Tax rates.**
  This will require to be dealt with as part of the Budget 2009 package

- **EU developments on tax.**
  Issues in relation to proposals for a Common Consolidated Corporate Tax Base (CCCTB), and VAT issues dominate our EU agenda at present. As regards CCCTB, we have been under considerable pressure from the Commission, but extensive efforts to develop an alliance of sceptical member states, in conjunction with the Department of Foreign Affairs, appear to be bearing fruit, and there should be considerable opposition to any proposal which the Commission might issue later this year. Commissioner McCreevy has been a vocal opponent of the proposition. We are also under pressure from the EU to change various elements of our tax code in relation to which they argue that we are infringing either Treaty or directive provisions.

- **Revenue Commissioners**
  The Minister normally meets with the Chairman (Josephine Feehily) about every month for an update on the administration of the tax system.

- **Financial services issues**
  Domestic and EU developments. Considerable attention is being paid to some crucial EU financial services directives and policy issues as well as strengthening financial stability planning arrangements working with the Central Bank and the Financial Regulator. Liquidity in financial markets is creating a challenge for credit institutions internationally, many of which are reducing their ambitions in relation to lending. Ireland is not an exception to this. <u>You will be briefed orally on this by the Governor of the Central Bank at the first available opportunity</u>. Normally the Minister meets with the Governor about every month or two months.

- **Other**
  We are also expecting the outcome of discussions between the Registrar of Credit Unions and ILCU on the reform of the Savings Protection Scheme for credit unions

2. Staffing (Tab 5)
Regarding staffing and other needs of your office, the Personnel Officer, Mr. Des O'Leary is available to deal with any issues that arise. You are being provided with separate material dealing in more detail with the staffing of the Department, including the Minister's Office.

3. Statement of Strategy (Tab 6)
You are also being provided with a copy of the Department's Statement of Strategy 2008-2010. This sets out our mission and the strategic priorities that ensure the mission is successfully fulfilled.

You will be aware that Section 4(b)(ii) of the Public Service Management Act 1997 requires the Secretary General of a Department to submit to the Minister a strategy statement in respect of that Department within six months of the appointment of the Minister or at an earlier time if the Minister so requires. Accordingly, we will prepare a new strategy statement for the Department to be submitted to you.

4. EU legislation/ infringements (Tab7)
The attached brief includes material on EU legislation/ infringements relevant to this Department.

5. Some Key Dates
Some key dates that are likely to arise over the next few months are set out below. Oral PQ dates are not included since these will be rescheduled to reflect the composition of the new Government.

13-14 May	Eurogroup/Ecofin (Brussels)
2/3 June	Eurogroup/Ecofin (Frankfurt/Luxembourg)
11 June	North South Ministerial Council (tentative, N.I. venue)
Early July	Budget Strategy Memorandum to Government
7-8 July	Eurogroup/ Ecofin (Brussels)
12-13 September	Informal Eurogroup/ Ecofin (Nice, France)
6-7 October	Eurogroup/Ecofin (Luxembourg)
Mid-October	Pre Budget Outlook published
10-13 October	IMF/ World Bank meeting (Washington D.C.)
17-31 October	Ministerial Bilaterals on Budget Day expenditure provisions
3-4 November	Eurogroup/ Ecofin (Brussels)
1-2 Dec	Eurogroup/ Ecofin (Brussels)
3 December	Budget Day*

*Budget day is traditionally held on the first Wednesday in December which is early given that some large taxes are paid at end-November. The more detailed budget calendar can be found under the Divisional briefing on BEPD at Tab 1 and is based on a 3 December date in line with tradition. Your approval will be required in due course in terms of the actual date.

6. Detailed Briefing for Each Division
I am available, together with the management of each of the Divisions, to go through the issues set out above and in the attached briefing notes in more detail.

7 May 2008

18/02/2008 17:55

21/MMG/35

Briefing Document.

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between them account for almost half of the total FDI stock in Ireland, largely due to their role as intermediaries for US investment.

FDI by Ireland abroad

Irish residents invested €11.7 billion abroad in 2006, compared to €11.9 billion in 2005. The cumulative stock of Irish FDI abroad rose by €5.3 billion in 2006 to €93.6 billion. In the first three quarters of 2007, Irish residents directly invested another €13.3 billion abroad.

18% of the stock of Irish FDI abroad in 2006 was invested in manufacturing enterprises, with the rest in services. Included in services investment is the financial intermediation sector, which accounted for 35% of the total FDI stock. Other services activities, the bulk of which relates to property investment, accounted for 30% of FDI stock. The end-2006 position for Irish FDI abroad was 26% invested in the UK, 41% in the rest of the EU, 12% in the US and 21% in the rest of the world.

	FDI in Ireland	Irish FDI Abroad
Manufacturing	27%	18%
of which Chemicals	9%	3%
Services	73%	82%
of which Financial/Insurance	57%	35%
of which Property	NA	30%

Financial Stability: Banking on Prudence

General comment

The Irish authorities welcome the recognition in the report that the Financial Regulator;

1. is a highly respected institution,
2. has been recognised as such in IMF reports on the regulatory system, and
3. had acted proactively in introducing forward looking liquidity regime in advance of recent financial market turmoil.

The report also correctly points out that the Irish banking system entered the current period of international financial turmoil in a particularly strong position in terms of earnings and asset quality. While there has been an ongoing adjustment in housing prices since the latter half of 2007, the most recent Financial Stability Report (14 November, 2007) prepared by the Central Bank and Financial Services Authority of Ireland reported that the Irish banking system continues to be well placed to withstand adverse economic and sectoral developments in the short to medium term. That report highlighted that:

- When assessed on the usual indicators such as asset quality, profitability, solvency, liquidity and credit ratings, the Irish Banking system is robust.
- There have been a number of welcome improvements with respect to domestic risks since the Financial Stability Report 2006 was published.

    - The upward momentum in residential property prices has abated, thus reducing the vulnerability posed by the previous substantial increase in house prices.
    - Fundamentals in the Housing market remain strong.
    - The rate of credit growth has eased and the rate of accumulation of private-sector indebtedness has moderated accordingly.
- The strength of the Irish economy continues to support the stability of the financial system. Growth projections (though suhsequently reduced) remain positive and reasonably good hy international standards in light of current global economic conditions.

Consideration of issues in the adjustment in Irish property prices should have regard to this assessment, Ireland's participation in the ESCB and the wider EU economy.

General comment on Deposit Guarantee and bank insolvency regime

Ireland's approach to Deposit protection and banking insolvency sits squarely in the mainstream of European law and practice. Ireland is one of 10 of the EU countries (some of which are considerably larger economies), which provide deposit protection to a level of €20,000 as provided for in EU Directive 94/19/EC, sufficient to provide protection to the vast majority of depositors. Similarly, while there is provision in some EU countries for special treatment of banks within insolvency law, Ireland's approach is consistent with the majority of its European partners[8].

In circumstances where the Irish approach to these issues is consistent with the majority of our European partners, the Irish authorities cannot accept comment relevant to the general reform of these schemes that is articulated in a report unique to Ireland. Any such comment should, in the first instance, be directed to a review of general (European) practice, such as the review of Deposit Guarantee Schemes currently being undertaken in the context of the EU Roadmap in response to financial market turmoil. While this is the strongly held position of the Irish authorities, it is particularly important in the current circumstances where such comment, if positioned in the context of a particular country, could be misinterpreted or misrepresented in relation to financial stability issues. In this context, the Irish authorities note the high standing and reputation of the OECD in Ireland and other countries, underlining the need for care and proper consideration to be given to the potential impact of any comment it might make, particularly where such comment relates to matters that have relevance to the national economy.

Recommendations in Box 3.1

Consider making pay-outs from the deposit guarantee scheme faster and increase the guarantee fund.

<u>Comment</u>

While the EU Financial Services Committee has identified speed of payment as a critical issue in its review of Deposit protection Schemes, it has identified significant

[8] It is noted that the UK, a similar common law jurisdiction to Ireland, has commenced a public consultation process in relation to Financial Stability and Depositor Protection, including consideration of a Special Resolution Regime (SRR) to reduce the impact of a failing bank.

challenges to be overcome; pointing out that speed of payment is dependent on information on depositors and funding, acknowledging that creating a system for near instantaneous information availability may impose high administrative costs on banks and supervisors. Ireland is currently participating in an EU review looking into the possible enhancement of deposit guarantee schemes within the EU. The parameters of the Irish deposit insurance scheme will be reconsidered in the light of the findings of the EU study. As indicated above, the Irish authorities consider it inappropriate that this recommendation be positioned in a report on a particular country, or that it anticipate the outcome of work at European level in which Ireland is participating.

Implement an insolvency procedure specifically adapted to banks.
Comment:

The introduction of a special insolvency regime for banks would require a radical change in the Irish statutory insolvency regime and could not be undertaken without wide consultation and careful study to assess its full implications. One of the main underlying objectives of a special insolvency regime for banks is to expedite payments to depositors in the event of a bank failure. It may be possible to achieve that objective through other reforms to the deposit insurance arrangements. Again, the Irish Authorities consider it inappropriate that this recommendation be positioned in a report on a particular country.

While the foregoing paragraphs relate to deposit protection and insolvency regimes, the report (Box 3.1) also makes recommendation in relation to ratings agencies and approaches to off-balance sheet exposures. Here again the Irish authorities are participating in work at European level in relation to enhancing transparency and the role of ratings agencies. The latter in particular are not amenable to action by one, small, country. The Irish authorities would be concerned at the presentation of these recommendations in a report on one country.

General speaking point

- The Irish authorities welcome the recognition in the report that the Financial Regulator;
  1. is a highly respected institution,
  2. has been recognised as such in IMF reports on the regulatory system, and
  3. had acted proactively in introducing forward looking liquidity regime in advance of recent financial market turmoil.

- The report also correctly points out that the Irish banking system entered the current period of international financial turmoil in a particularly strong position in terms of earnings and asset quality - this positive assessment is borne out in the most recent assessment of the Irish Banking system in the CBFSAI's Financial Stability Report (14 Nov. 2007).

- Ireland's approach to deposit protection and banking insolvency sits squarely in the mainstream of European law and practice.

- In circumstances where the Irish approach to these issues is consistent with the majority of our European partners, the Irish authorities cannot accept comment relevant to the general reform of these schemes that is articulated in a report unique to Ireland.

- Furthermore, while reform of both deposit protection and insolvency arrangements is advocated in the report, there is no analysis as to the appropriateness, cost effectiveness or workability of these recommendations in an Irish context.

- Having regard to the standing and reputation of the OECD in Ireland and other countries, care and proper consideration needs to be given to the potential impact of any comment it might make, particularly where such comment relates to matters that have relevance to the national economy or financial system.

- The Irish authorities note the report's caution (par 93) against going "into regulatory overdrive" in response to financial market turmoil, a position that is difficult to reconcile with report's advocacy of profound change in relation to deposit protection insolvency legislation for banks.

Deposit Protection Scheme (Deposit Guarantee Scheme - DGS). Speaking Point

- The Irish Deposit Guarantee Scheme complies with the EU Deposit Guarantee Directive and would provide protection to over 90% of depositors

- Ireland's approach to Deposit protection sits squarely in the mainstream of European law and practice. Ireland is one of 10 of the EU countries (some of which are considerably larger economies), which provide deposit protection to a level of €20,000 as provided for in EU Directive 94/19/EC.

- The EU Commission and the Financial Services Committee (FSC) have been requested by ECOFIN to consider possible enhancements of deposit guarantee schemes and to report back to it by mid-2008.

- Ireland is participating in an EU review and the Tánaiste and Minister for Finance has made it clear that the parameters of the Irish deposit insurance scheme will be reconsidered in the light of the findings of the EU study.

The Irish authorities cannot accept either the positioning of a recommendation for the reform of the Deposit Protection Scheme in a report on a single country, or that a sustainable case has been made for the recommendation advanced

1. Work on the review of the Deposit Protection Scheme is underway at EU level, and it is inappropriate to position a recommendation pre-empting the possible lines of reform in a report on a single country.

2. There is no analysis in the report as to the costs, benefits or changes that would be needed to make an enhanced DGS operable – in this context the views of the UK Banking industry as to the costs of to consumers of enhancing DGSs in that jurisdiction are relevant.

3. EU Financial Services Committee has identified speed of payment as a critical issue in its review of Deposit protection Schemes, but that there are significant

challenges to be overcome in this regard; pointing out that speed of payment is dependent on information on depositors and scheme funding, acknowledging that creating a system for near instantaneous information availability may impose high administrative costs on banks and supervisors. The OECD's report offers no consideration or analysis of these issues.

4. The report does not explain role is envisaged for a DGS i.e. is its primary purpose as a crisis management tool or consumer protection issue (or both), which has important implications for public authorities in terms of their overall financial stability contingency planning

5. Overall there is an absence of application of Regulatory Impact Analysis (e.g. effectiveness, proportionality, necessity) or testing of the recommendation as to its likely advantages nor is there any analysis to suggest it would it pass a CBA or Impact Assessment test.

6. While a good deposit protection regime can help support confidence in the banking system, it is difficult to conceive (nor does the OECD report provide any suggestion) as to how a deposit protection scheme could be put in place that can altogether pre-empt banking crises unless it provides such strong guarantees that it is causing major moral hazard.

Implement an insolvency procedure specifically adapted to banks

- The best safeguard of financial system is the existence and effective operation of the financial regulatory and supervisory regime and the system in Ireland has been positively assessed by the IMF as recently as September, 2007

- Ireland's approach to banking insolvency is consistent with the majority of its European partners.

- To attempt to introduce a special insolvency regime for banks would require a radical change in the Irish statutory insolvency regime and could not be undertaken without wide consultation and careful study to assess its full implications.

- Work to date on financial stability issues has not highlighted insolvency law as a major issue for the reform process overall

- While the report presents some analysis of the functioning of a special insolvency regime for banks in the US, this needs to be understood in the context of the US market with a large number of relatively small banks, presumably catering for local savers fail (with a relatively high frequency of failure). While it makes sense to a have access to an insolvency regime which allows you re-unite depositors with their savings and wind-up the institution concerned quickly in such circumstances, the report makes no analysis of the differences in banking practice, regulation or size in an Irish (or European) context

The Report sets out no analysis to justify the introduction of a special insolvency regime for banks either in Ireland or generally in Europe and this recommendation is unacceptable as currently presented.

1. The creation of a special insolvency regime would 'carve out' a special position for retail depositors, but could have significant 'unintended' consequences on investor perceptions of banks and their ratings in view of the impact it would have on the ordering of other creditors. The OECD report provides no analysis or insight as the broad range of considerations that would be needed to inform this analysis

2. As in the case of Deposit protection, the report makes no analysis as to whether a special insolvency regime is intended as part of the toolkit for crisis management or whether it is considered a better way of protecting the interests of depositors than a deposit guarantee scheme.

3. Again, as in the case of deposit protection, there is an absence of application of Regulatory Impact Analysis (e.g. effectiveness, proportionality, necessity) or testing of the recommendation as to its likely advantages nor is there any analysis to suggest it would it pass a CBA or Impact Assessment test.

4. for a large sophisticated financial institution in Ireland, insolvency by its very nature it likely to be substantially more complex and unlikely to lend itself to such a 'quick-fix'....the scope for a 'carve-out' of some retail depositors would presumably promote behavioural changes among wholesale / corporate depositors and indeed wholesale lenders and investors. The report provides no guidance as to how a special regime could be designed that would seek to return all deposits (particularly given that it would come into play in circumstances that the institution was insolvent - unable to meet its obligations)

Additional material – Colm Breslin

On the basis of its views in relation to the Irish Deposit Guarantee Scheme (DGS), it would appear that the OECD needs to rethink and articulate its views as to the role and impact of DGSs in crisis management in the banking sector.

The CBFSAI has indicated that our EU-Directive compliant compensation ceiling of €20k would meet the needs of 90% of retail depositors. At the time that Northern Rock got into difficulties, its compensation ceiling stood at £35k (€52.5K approx) and it can be assumed that the vast majority of Irish-based depositors would have been fully covered by this ceiling. Moreover, the DGS is independent of and external to the bank in trouble. Nevertheless there was a run on the bank by, inter alia, its Irish-based depositors.

Clearly, therefore, the level of the DGS and the fact that it is independently secure is immaterial to depositors when they are considering their response to a bank in trouble. The OECD might therefore need to reconsider its views as to the role and impact of DGSs in the context of a bank crisis.

Fiscal Council

As regards a National Fiscal Council, the ESRI and the Central Bank provide a de facto non partisan expert advice in the public debate on fiscal policy. It would be inappropriate to try to impose what appears to be a congressional style budget committee approach on a parliamentary democracy.

Housing

General

It is difficult to disagree with the general thrust of the analysis of the state of the Irish housing market, which, in any event seems to be broadly positive, while recording some fairly well known risks. Regarding the comments and suggestions on policy relating to the housing market, the idea of considering the approach to policy in this area may be worth exploring, but without prejudice to the particular suggestions put forward. These mainly relate to aspects of fiscal policy impacting on the housing market, which is a matter for the Department of Finance.

One further general point in relation to the housing market analysis is that a more nuanced approach would be desirable with regard to the relative importance of different factors impacting on the market at different times. In particular, there is a distinction to be drawn between the earlier phase of expansion and price increase up to around 2004, which, as the economic modelling results cited in the report indicate broadly mapped the growth pattern in economic fundamentals, and the escalation post-2004, which departed significantly from the fundamentals due, it would seem, to the impact of other factors. This issue is dealt with further in the specific comments under.

Specific Aspects

Tax Treatment of Housing

The tax-related issues referred to are matters for the Department of Finance. However, a general conclusion that seems to emerge is the desirability of attuning fiscal measures as closely as possible to changes in the market.

The suggestion about moving towards a system of means-tested benefits would need to be treated with caution. Indeed it is not desirable that a specific recommendation in that regard should be included without rigorous justification. There is a very wide body of literature about the housing benefit approach internationally and significant difficulties (not least practical issues such as cost, complexity and administrative

difficulty) as well as possible advantages, have been identified in different countries. The issue was looked at in the Irish context by a series of Committees which examined the rent supplement system and related housing issues in this country since the mid 1990s and the balance of arguments was found to be against such a move. Indeed the Rental Accommodation Scheme (RAS) can be regarded, to some extent as an alternative to such an approach. RAS is designed to take account of the particular issues that arise in the housing sector in Ireland while addressing disadvantages with the SWA rent supplement scheme as a means of providing long term housing assistance and avoiding problems that have been encountered elsewhere with housing benefit approaches. Further material can be provided to OECD on these issues if required.

Mortgage Lending Policy

There seems to be an implication that increased lending was largely or entirely a consequence of booming property markets (e.g. "This raised bank lending substantially…") whereas the converse was to a significant degree the case. There were significant changes in mortgage lending practices around 2005 (100% mortgages marketed aggressively at first time buyers, 35 and 40-year loans and interest-only mortgages). This helped to fuel price escalation directly through increased liquidity in the market and also through interaction with price expectations, on which expansive lending was partly predicated.

House Prices

The statement that house prices could even fall below their medium-term sustainable level is questionable. It is not entirely self-evident what the 'medium-term sustainable level' is and prices arguably have scope to reduce more to unwind the escalation that occurred in 2005/06 without being considered abnormally or unsustainably low. Notwithstanding recent cooling, there are probably still affordability problems in some areas, particularly in Dublin. Reference to lending and price expectations as factors helping to drive prices would is warranted

While sales are down throughout the housing market, the statement that "Residential investment is experiencing a sharp slowdown" seems too strong. Indeed there are some counter indications such as developers releasing blocks of units to the rental market, lack of evidence that the share of lending to this sector has declined appreciably (the Central Bank has reported a large proportion of lending stock in the residential investment sector). In addition rental yields have been growing in response to decline in capital values and demand from potential homeowners and new immigrants. Such yields should entice investors into the market as house prices may be perceived to be better value for money for investors as well (especially given the negative performance in equity markets).

Increasing Rents

Reference to recent rent increase should be balanced by indicating that the longer trend is quite moderate e.g. since December 2001, an average increase of just over 2% per annum and almost certainly a decline in real terms. Apart from affordability (which is improving) a factor in increased renting is that people are holding off buying because they expect prices to fall further.

There would appear to be a degree of anomaly in concluding that the recent rise above the fundamental trend has been driven by higher incomes and demographic factors – surely the latter would be included as "fundamentals" in the economic model. Again, this brings additional factors such as lending and price expectations very much into the picture. Points such as "This may overstate the effect on prices of demographic effects given that the large number of migrants who arrived in the past two years are more likely to rent and live in high density housing" does not seem correct. It is immaterial whether an immigrant household is accommodated in a rental or owner-occupied unit – they are adding to overall demand for housing and thereby exerting some influence on price in either case.

Housing Benefit and Social Housing

We would have serious difficulty with the unqualified endorsement of housing benefit. It is not feasible to deal with the fiscal aspects in this context. However, the general thrust of the OECD view about the need to have regard to alternative approaches in the absence of monetary policy instruments would seem to warrant consideration. The recent cycles of escalation and downturn would seem to lend credence to this but particularly the fact that, although trends in mortgage lending were identified in mid-2005 as a significant threat to house price moderation, it did not prove possible to pursue any action to moderate this factor.

We would question the comment "no progress" in relation to social housing and tenure options. We would very much feel that the RAS scheme represents important progress in this general area which should develop significantly in the future as an additional option in meeting social housing need in partnership with the private sector. On the question of possible change in relation to mortgage interest relief, while the economic rationale for the OECD view is noted, any possible changes in that regard would need to take account of prevailing market conditions.

Integration/Migration

Comment on current policy – language usage:

As a general rule we do not use the word assimilation we use integration. They are not interchangeable. Assimilation is used throughout the report, this is not Irish Government policy.

General Observations:

Over 1 million euros was spent by the HSE last year on interpretation services alone, but giving only this figure doesn't provide the full picture. In the education area, there are now over 1,900 English language resource teachers in place which will cost over €120m as compared with the situation in 2001/2002 when there were 260 such teachers. In addition, the DES funds Integrate Ireland Language and Training (IILT) and the National Council for Curriculum and Assessment (NCCA) have prepared materials to help schools cater for the integration of the migrant children.

Overview of Financial Stability Resolution Issues

Department of Finance

Friday, 8 February 2008

SECRET

Context

- EU requirement for national contingency plans for crisis resolution
- Report-back due for April ECOFIN (report to FSC in March)
- CBFSAI 'Red Book' in place
- Work has commenced on DoF operational manual based on
  - Scoping paper & CBFSAI comments
  - legal advice from Office of the Attorney General
  - Lessons from Crisis Simulation Exercise (December 2007)
- Policy decisions required to finalise a number of key "resolution" issues highlighted by work of the DSG to date

National Contingency Plans

- Integrated and consistent national approach essential
- Individual organisational plans will reflect different roles and responsibilities in effective crisis management and crisis resolution
- Must be soundly based on rigorous analysis and research on
  - Legal consideration governing crisis management
  - Preferred solutions (national policy objectives)

Previous conventional wisdom

- Intervention only if institution considered TBTF
- Otherwise institution should be allowed to fail
- Request to CBFSAI for ELA provision from financial institution
  - inauguration of financial stability event
  - lead responsibility for crisis management during that phase residing with CBFSAI
- Department's direct involvement predicated on the emergence of 'solvency' as opposed to 'liquidity' issues

Current viewpoint

- If confidence fragile then small institution could trigger systemic difficulties which suggests all institutions are TBTF (in current market environment)
- 'Market discipline' may not be useful tool as insolvency (let it fail) not practical owing to weaknesses in DGS
- Increasing consensus that a "support operation" likely to trigger wider systemic problem
- Also 'solvency assessment' could often be an abstract / contentious exercise reflecting such issues as information gaps and valuation uncertainties, shaped by strict accounting / legal definitions, influenced by market conditions and particular assumptions

Current viewpoint continued...

- In identifying the way forward very important to differentiate between short- & medium- term actions / policy responses feasible
- Current contingency plans must be designed around what is currently permissible under the existing legislative framework and what might be changed over relatively short timeframe
- Unlikely that more fundamental structural reforms if concluded to be desirable (e.g. special insolvency regime for banks) could be achieved quickly

Lessons from recent crisis management

- Every crisis has unique characteristics but has common themes
- There are risks from extrapolating too strongly from Northern Rock experience, but it would be prudent to examine particular lessons:
  - Announcement of BoE support operation triggered bank run in Northern Rock and risked systemic crisis
  - DGS did not maintain public confidence
  - Resulted in very substantial public exposure (BoE loans, HMT guarantees)
  - Highlighted the risk in those circumstances that to maintain financial stability the State is left with no option other than to provide open-ended 'guarantees'

Lessons continued...

- **Key question – could Irish financial system accommodate crisis resolution approach adopted by UK for Northern Rock? (e.g. would the scale of lending / State "guarantees" required be credible)**
- With the benefit of hindsight, 'covert' private sector takeover presented as *fait-accompli* to market preferable approach
- Issue for financial stability planning in Ireland is whether covert takeover legally feasible
- If so, how financial stability planning can be designed to expedite / maximise the prospect of success

Proposed framework for crisis resolution

- Overarching Principles
  - Earliest possible warning / identification of possible threats to financial stability and swift resolution critical[1]
  - Need for a number of options for early intervention

[1] CB/FR to have, on a continuous basis, all information for ongoing assessment of sustainability of financial institutions

Proposed framework for crisis resolution cntd.

- Three primary options should ideally be available for consideration in advance of any financial stability issue coming into the public domain:
  - Orchestrated market-based solution (i.e. non-publicly organised private 'take-over' / re-capitalisation – depending on scale may require involve Irish banks, international banks, outside investors)
  - Examinership (may not be readily available – consideration of reform of DGS required to underpin credibility)
  - Nationalisation as a last resort but to pre-empt requirement for extended period of ELA support and attempted public rescue

Framework for crisis resolution contd.

- The three primary options should ideally be available for consideration in advance of any financial stability issue coming into the public domain:
- **As a matter of public policy to protect the interests of taxpayers any requirement to provide open-ended / legally binding State guarantees which would expose the Exchequer to the risk of very significant costs are <u>not</u> regarded as part of the toolkit for successful crisis management and resolution**
- Legal advice obtained from the Office of the Attorney General on key aspects of the proposed framework
- In overall terms legal assessment favourable

MAD & ELA provision

- A financial institution could postpone disclosing to the market information that prompts a negotiation for ELA, provided that:-
  - the failure to disclose would not be likely to mislead the public (key issue identified by the OAG) and
  - the financial institution was able to ensure the confidentiality of the information
- Requirement of a *legitimate interest* would probably be met in these circumstances
- Strict obligations of confidentiality would apply to CBFSAI and DoF
- CBFSAI would be under obligation to ensure that MAD obligations are complied with
- Definitive advice could only be given in a particular context having regard to the two conditions above
- Impact of ISE rules require further examination

Takeover Rules

- Public authorities could facilitate the non-public takeover of a distressed financial institution **if** the Takeover Panel granted a derogation from its Rules given the exceptional circumstances
- This waiver would also meet MAD requirements
- Competition clearance likely to be required from the EU Commission (or TCA)
- Takeover could be made conditional on such approval
- Early consultation with the EU Commission is recommended

Nationalisation

- CBFSAI itself has express statutory power to purchase shares in a credit institution with the approval of the Minister for Finance
- Express statutory authority would have to be provided for the purchase of a credit institution in the name of the Minister or Government
- Existing legislative provision could not be relied on – draft Bill would need to be prepared
- Would have to provide for compensation for shareholders (possibly with level of compensation worked out subsequently)
- Nationalisation could probably not be effected if the institution was under the protection of the Courts

State Guarantees

- The Minister does not have statutory authority to issue a guarantee
- This would not prevent the Minister announcing his intention to give a guarantee or his intention to protect deposits and then putting in place the necessary legislative measures
- It would be more appropriate to have the necessary draft legislation for a guarantee in place in advance

State Guarantees

- Clarity essential regarding different types of State 'guarantees' that may arise under financial stability event including
  - 'conditional' deposit guarantee as in the case of Northern Rock (may need to distinguish between retail and wholesale deposits)
  - guarantee in respect of CBFSAI liquidity support to distressed financial institution (e.g. in case of low-quality collateral)
  - State guarantee to underwrite a Bank's solvency position (could only be justified in circumstances that otherwise the entire financial system is at risk of collapse)

Legal advice – CBFSAI ELA

- The Minister may request the CBFSAI to consult with him both with regard to the provision of an ELA and the terms and conditions on which it may be provided. The CBSFAI is obliged to comply with such a request
- Seeking to clarify the legal basis for the requirement [from CBFSAI Explanatory Memorandum on ELA] that in order for the CBFSAI to inject liquidity into an insolvent institution a Government guarantee of the institution's liabilities would be required

State Aid

- CBFSAI Liquidity support on commercial terms probably not a State Aid
- Other financial assistance, including guarantees <u>not</u> provided on commercial terms likely to constitute State Aid
- Commission requirements for approving State Aid in such circumstances
- October 2007 Ecofin conclusions invite the Commission to clarify when a major banking crisis might be considered by the Commission as falling within Article 87(3)(b) 9 ("a serious disturbance of the economy")

Emerging Conclusions

- Primary objective is to safeguard public / international confidence in stability of Irish financial system
- It is in the interests of the public that the situation is solved before it enters the public domain in order to prevent contagion
- Whether dealing with 'Big Bang' (SocGen/'Alpha Bank') type scenario or 'Slow Burn' (Nordic countries 1990s)
- Legal advice confirms that proposed framework for crisis resolution is broadly legally feasible
- Review and any necessary reform of DGS a priority given the requirement to ensure that examinership is a credit resolution option
- It is essential that clear roles and responsibilities are identified and the systems are put in place for organising a non-public takeover of a distressed financial institution

Main Policy Issues

- Contact the Competition Authority and the Commission regarding competition implications of courses of action
- Engage with Commission regarding state aid implications
- Clarify crisis resolution responsibilities particularly roles regarding orchestrating a market-based solution
- Prepare draft legislation for enactment as required for:
  - the provision of Ministerial guarantees
  - the nationalisation of a financial institution
- Review of Deposit Guarantee Scheme

Proposed Next Steps

- Department to finalise its proposed approach a paper on crisis resolution
- Seek the views of CB and FR through DSG
- Submit for consideration by MAC / top management
- Policy issues to be submitted for Ministerial consideration / approval
- Crisis manual to be prepared on the basis of policy decisions

29 April, 2005

MEMORANDUM OF UNDERSTANDING ON CO-OPERATION BETWEEN THE BANKING SUPERVISORS, CENTRAL BANKS AND FINANCE MINISTRIES OF THE EUROPEAN UNION IN FINANCIAL CRISIS SITUATIONS

Introduction

The agreement of the Parties leading to this Memorandum is based on the following considerations:

(1) The integration of financial markets and market infrastructures in the European Union (EU), together with the growing number of large and complex financial institutions, increases the scope for cross-border contagion and thus the likelihood of a systemic crisis affecting more than one Member State. In this context, it is important to have in place practical arrangements concerning co-operation in cross-border crisis situations at the EU level among the authorities potentially involved in preserving financial stability.

(2) The framework defined in this Memorandum will apply to crises which may have a potential for both cross-border and systemic impact affecting individual credit institutions, banking groups or banking components of financial groups, as well as to other possible systemic disturbances with cross-border implications, including those affecting payment systems or other market infrastructures.

(3) Co-operation between banking supervisors, central banks and Finance Ministries will take place in accordance with, and without prejudice to, their responsibilities under national and Community legislation, as well as the Treaty. In particular, in the context of this Memorandum, supervisory responsibilities should be interpreted in accordance with the applicable Community directives, including the role of consolidated supervision. Central banks' responsibilities should be interpreted with regard to their capacity as monetary authorities and overseers of payment systems, as well as their overall responsibility for contributing to the stability of the financial system as a whole. Finance Ministries' responsibilities should be interpreted with regard to their public accountability for the management and resolution of systemic crises.

(4) The Parties emphasise that this Memorandum is designed to facilitate the management of cross-border systemic crises with a view to safeguarding the functions of the financial system. The potential systemic implications of a crisis affecting a financial institution may require the involvement of banking supervisors, central banks and, in certain circumstances, of Finance Ministries. Such involvement should not be construed as representing an exception to (i) the principle of the firm's owners'/shareholders' primary financial responsibility, (ii) the need for creditor vigilance, as well as to (iii) possible market-led solutions to solve a crisis situation in individual institutions.

(5) Information-sharing between banking supervisors, central banks and Finance Ministries, will take place in the context of this Memorandum, on the basis of existing practices and arrangements and subject to the applicable conditions for the transmission of confidential information set out in national and Community legislation. In particular, information-sharing is limited to those authorities whose policy-making functions may be affected by the crisis situation.

(6) This Memorandum is seen by the Parties as an appropriate instrument for setting forth arrangements aimed at promoting co-operation between them in crisis or potential crisis situations without overriding their respective institutional responsibilities or restricting their capacity for independent and timely decision-making in their respective fields of competence, notably with regard to the conduct of day-to-day central banking and supervisory tasks. In particular, the evaluation of the possible systemic importance of a crisis situation, which may be required to be transmitted to Finance Ministries in accordance with this Memorandum, remains within the scope of the autonomy of banking supervisors and central banks.

(7) The Parties acknowledge that crisis situations may in practice involve a wider range of authorities and respective functions, including other financial supervisory authorities, deposit insurance schemes and competition policy authorities. This Memorandum is without prejudice to further co-operation arrangements involving a wider range of authorities and may be reviewed accordingly. The Parties also acknowledge that certain crises may require international co-operation with authorities whose jurisdiction lies outside the EU. However, such co-operation is beyond the scope of this Memorandum.

(8) This Memorandum complements, and is without prejudice to, other present and future arrangements on co-operation between responsible authorities, particularly banking supervisors and central banks. In this context, the Parties will aim to ensure that co-operation and information-sharing in crisis situations take place in a manner consistent with the provisions and objectives of any other existing arrangements.

THE PARTIES TO THIS MEMORANDUM OF UNDERSTANDING AGREE TO THE FOLLOWING:

1. Objective of the Memorandum

The objective of the Memorandum is, building on the existing national and EU arrangements, to support and promote co-operation in crisis situations between banking supervisors, central banks and Finance Ministries through appropriate procedures for sharing information, views and assessments, in order to facilitate the pursuance of their respective policy functions and preserve the overall stability of the financial system of individual Member States and of the EU as a whole. In particular, these authorities should be in a position, if needed, to engage in informed discussions amongst themselves at the cross-border level in the case of crisis situations affecting the financial system of more than one Member State or the EU as a whole.

2. The scope of co-operation in crisis situations

2.1 Banking supervisors, central banks and Finance Ministries will co-operate at the national and cross-border levels in accordance with the framework set out in this Memorandum. Co-operation will primarily involve the exchange of information, views and assessments among the Parties.

2.2 This Memorandum shall apply to crises with both potential cross-border and systemic implications. In particular, the reference to "crisis" throughout this Memorandum shall include the following features of potential cross-border and systemic shocks:

(i) Crises affecting individual credit institutions;

(ii) Crises affecting banking groups or the banking components of financial groups; or

(iii) Other systemic disturbances, including those affecting payment systems, other market infrastructures or financial markets;

which may warrant the involvement of Finance Ministries.

2.3 The co-operation procedures specified in this Memorandum may also be activated, at the discretion of the Parties involved, to exceptional events likely to lead to public concern and seriously affect the financial systems of more than one Member State.

3. Responsibilities in crisis situations

3.1 Efficient co-operation among authorities is expected to take place on the basis of the existing institutional and legal framework for financial stability in Member States, as well as the applicable Community legislation, fully respecting the roles and responsibilities of banking supervisors, central banks and Finance Ministries.

3.2 The co-operation between banking supervisors, central banks and Finance Ministries will be intended to enable each authority to fulfil their respective tasks and responsibilities, in accordance with Community and national legislation.

4. Activation of co-operation procedures

4.1 A crisis situation referred to in this document is not definable ex ante. It remains within the discretion of the responsible banking supervisors and/or the central banks to determine whether a crisis is emerging or developing for the purposes of this Memorandum. In the case of a potential crisis situation, co-operation procedures are expected to be activated in a timely manner.

4.2 Any of the Parties may transmit or request relevant information if a potential crisis situation appears to be developing, and joint discussions may be initiated at the request of any of the Parties.

5. Procedures for the sharing of information

5.1 Subject to the conditions set out in this Memorandum, the banking supervisors or the central banks that have access to information related to a potential crisis situation will provide their

respective Finance Ministries with information regarding material developments or concerns including where possible, an assessment of potential systemic and cross-border implications, which may require their involvement.

5.2 Subject to the conditions set out in this Memorandum, the Finance Ministry of each Member State will provide the respective banking supervisor and central bank with any relevant information on the potential crisis situations that may be received from other entities, particularly Finance Ministries from other Member States.

5.3 The concrete items of information to be shared between the Parties may include views and qualitative assessments and, where relevant, specific information on, such as:

(i) Potential systemic implications for the domestic financial system; where possible, consideration should also be given to the systemic impact on other Member States' financial systems as well as on the EU's financial markets as a whole;

(ii) Where possible, on specific channels of contagion of the crisis to institutions, markets and market infrastructures;

(iii) Where possible, consideration of other relevant economic implications of the crisis situation;

(iv) Where possible, any constraints to the implementation of policy measures;

(v) Updates of relevant developments and related information.

5.4 The specific information needs, and the authorities to be contacted, shall be determined by the Parties in light of the particular features of the potential crisis. In particular, information shall only be shared among those Parties of each Member State whose policy-making functions may be affected by the crisis situation in view of the likely effects of the crisis on institutions, markets or market infrastructures within the competence of those authorities.

5.5 The Parties undertake to provide each other, where relevant and subject to Community and national law, and in accordance with the procedure set out in Section 7.1, with advance notice of any policy measures that may be undertaken in the context of the crisis situation, without prejudice to urgent decision-making by the responsible Parties.

5.6 The Parties involved in a crisis situation will, to the extent possible, co-ordinate jointly any statement to the public by discussing the appropriate content of such communication beforehand.

6. Co-operation at the national level

6.1 At the national level, the Parties will co-operate and share information in accordance with existing laws, institutional arrangements and procedures.

6.2 In order to cope with the situations described under Section 2, it is desirable that appropriate arrangements and procedures exist at the national level on mutual co-operation and exchange of information on common general issues related to financial stability among at least banking supervisors, central banks and Finance Ministries. Although the details of such arrangements are at the discretion of the Member States the arrangements should contribute to facilitating the

operation of this Memorandum as well as setting out contingency plans in case of a potential national or cross border systemic crisis.

7. Co-operation at the cross-border level

7.1 At the cross-border level, banking supervisors, central banks and Finance Ministries, as a rule, will correspond with their respective counterparts in other Member States. At the discretion of any of the Parties, information may however be transmitted directly at the cross-border level between different types of authorities with concurrent transmission to the relevant counterpart authorities of the relevant Member State(s).

7.2 A crisis affecting more than one Member State may warrant multilateral co-operation among the Parties involved. In particular, measures in potential systemic and cross-border crises may need to be based on a common understanding as well as on assessments of the situation shared among the relevant authorities in several Member States. In such situations, those authorities involved or likely to be involved will decide on the most appropriate means for communication, information-sharing and co-operation among them.

7.3 In cases where wider multilateral co-operation among the Parties needs to be activated, such as in major disturbances that may affect the EU as a whole or several Member States, existing EU-committees may provide a platform for exchange of information, views and assessments.

8. Confidentiality

8.1 Any information exchanged and received by virtue of the application of the provisions of this Memorandum is subject to conditions of confidentiality and professional secrecy as provided in Community and national legislation.

8.2 The Parties will maintain, vis-à-vis third parties, the confidentiality of any request for information made under this Memorandum, the contents of such requests, the information received, and the matters arising in the course of co-operation without prejudice to relevant Community and national provisions.

8.3 The Parties will ensure that all persons dealing with, or having access to, such information are bound by the obligation of professional secrecy.

9. Crisis arrangements and contingency planning

9.1 The Parties will endeavour to develop, as well as to test and update on a regular basis, at the national and EU levels, contingency arrangements for managing crisis situations as well as conduct stress-testing and simulation exercises. The primary goal of such exercises would be to enhance the preparedness of authorities for handling potential crisis situations with cross-border systemic implications. The Parties may wish to share, utilising the existing EU committees, the methods and assumptions used in organising and conducting such stress-testing at national level.

9.2 As part of contingency arrangements, the Parties will organise emergency contacts lists at the national and EU levels including the indication of contact points, other public and private bodies

that could be involved in a crisis situation, relevant sources of information, as well as all other means which could be regarded as necessary for the effective management of a crisis.

10. Further development of co-operation arrangements

10.1 The principles of co-operation provided in this Memorandum may also be implemented on a domestic or bilateral/multilateral basis by the Parties in accordance with their specific needs involving individual institutions, specific banking groups or the banking components of financial groups.

10.2 The Parties may, by common consent, invite other sectoral supervisory authorities and deposit insurance schemes of the Member States as well as Central Banks, supervisory authorities and Finance Ministries of the Contracting Parties of the European Economic Area to become parties to this Memorandum.

10.3 The Parties to this Memorandum will review this Memorandum periodically and consider necessary amendments within three years, if warranted in the light of experience or relevant developments – of its entry into effect.

11. Nature of the Memorandum

11.1 As the provisions of this Memorandum are not legally binding on the Parties, they may not give rise to any legal claim on behalf of any Party or third parties in the course of their practical implementation.

11.2 The provisions of the MoU do not prejudge or assume any particular decisions or remedies to be taken in crisis situations nor do they imply any change to or commitment to change existing national legislation.

12. Entry into effect

This Memorandum shall enter into effect on 1 July 2005.

Annexes:

1. Description of the roles and tasks of the Economic and Financial Committee (Financial Stability Table), the ESCB Banking Supervision Committee, Committee of European Banking Supervisors and Financial Services Committee.
2. List of signatories.

Annex 1

ECONOMIC AND FINANCIAL COMMITTEE

(FINANCIAL STABILITY TABLE)

The Economic and Financial Committee shall carry out the tasks described in Paragraphs 2 and 4 of Article 114 of the Treaty establishing the European Community. In accordance with Treaty Article 114(2), the EFC is the Ecofin Council's primary source of advice on issues concerning economic and financial developments, including on financial stability. According to its working methods, the EFC, as a rule, convenes about one week ahead of Ecofin Council meetings. Committee meetings, in full and restricted composition as well as in any of the three specific formats, are clustered in one- or two-day meetings per month in Brussels. Meetings are confidential.

The EFC meets at least semi-annually in its Financial Stability Table (FST) format and prepares the discussions on financial stability for the informal meetings of Ministers and Governors. When meeting as FST, the Committee may invite relevant non-members to attend as appropriate. The FST convenes at least twice a year. The FST brings together high-level representatives of finance ministries, the Commission, the European Central Bank, national central banks and supervisors[1], each contributing to the discussion by producing assessments from different angles. The EFC President determines the most efficient means of preparation according to the topics under consideration; for instance, by forming small ad-hoc working groups, or by asking relevant committees for contributions in their fields of competence.

The main aim of the FST is to develop well-informed assessments of financial conditions and risks within and across sectors for the purpose of informing Ministers and Governors and for sharing up-to-date information on EU-level developments between those responsible for preparing policy actions across the EU. As a result, EFC members should be in a better position to alert Ministers and Governors to potential problems relating to the stability of the EU's financial markets. The FST should ideally identify needs for policy actions. The FST format supports the information-sharing and economic policy-making in exceptional situations by providing a platform for communication between finance ministries and central banks and representatives of European supervisory authorities.

The EFC is assisted by secretariat acting on the instructions of the Committee when carrying out its responsibilities. The Secretariat is equipped with means of communication ensuring quick and confidential contacts with its members.

[1] Supervisory authorities are as a rule represented by the Chairmen of the Committee of European Banking Supervisors (CEBS), the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and the Committee of European Securities Regulators (CESR).

BANKING SUPERVISION COMMITTEE

OF THE EUROPEAN SYSTEM OF CENTRAL BANKS

The Banking Supervision Committee (BSC) is an ESCB committee which assists the ESCB in the fulfilment of its statutory tasks in the field of prudential supervision of credit institutions and the stability of the financial system. The BSC is composed of members from national central banks, banking supervisory authorities and the ECB which also provides the Secretariat.

The BSC has three main tasks:

- monitoring and assessing developments in the euro area/EU banking and other financial sectors from a financial stability perspective. In this context, the BSC also contributes to the production of regular reviews of financial stability conditions and prospects within the euro area/EU;
- analysing the impact of regulatory and supervisory requirements on financial system stability and structure, and financing conditions in the economy. In this context, the BSC also assists, where appropriate, in the preparation of the ECB's advice on draft Community and national legislation on prudential supervision of credit institutions and the stability of the financial system;
- promoting co-operation and exchange of information between central banks and supervisory authorities on issues of common interest. This includes devising and maintaining arrangements for co-operation and exchange of information relevant for the smooth conduct of their respective tasks and the prevention and effective handling of financial crises. At its own discretion, the BSC can also exchange information on supervisory issues not related to the statutory tasks of the ESCB.

In the context of its third task, the BSC has prepared in 2003 the Memorandum of Understanding (MoU) on high-level principles of co-operation between the EU banking supervisors and central banks in crisis management situations. As part of this MoU, the BSC is expected to support multilateral information-sharing in crisis situations by providing a platform for communication between banking supervisors and central banks. This BSC function would be assisted by the infrastructure of the ECB.

COMMITTEE OF EUROPEAN BANKING SUPERVISORS

The Commission Decision[2] establishing the Committee of European Banking Supervisors (CEBS) defines the main tasks of the Committee. The CEBS should provide advice to the Commission on implementing European legislation and contribute to consistent application of Community legislation, convergence of supervisory practice and co-operation between supervisors.

The Council[3] has furthermore stressed that the emphasis should be on convergence of supervision and implementation. Supervisory convergence, co-operation and information exchange is also called for from a financial stability perspective. CEBS' own Charter also notes that it will develop effective operational network mechanisms to facilitate the exchange of information in normal times and at times of stress.

CEBS members are high level representatives from the banking supervisory authorities and central banks of the European Union, including the European Central Bank.

The Committee was set up as a follow-up to the Lamfalussy report[4] which highlighted the need for faster and more flexible legislation, broad implementing powers for new committees and enhanced cooperation between regulators to ensure consistent implementation and application in Member States and stronger enforcement.

Open and public consultation is a central part of the Committee's accountability. The Committee is promoting open and transparent dialogue, interaction and co-operation with all market participants and end-users in its consultations. The Committee submits an annual report to the Commission and makes its work programme public. The Annual Report will also be sent to the European Parliament and the Council.

The Chair of the Committee reports periodically to the European Parliament, and when requested to the Council, and maintains strong links with the European Banking Committee. CEBS also participates as an observer on the Financial Services Committee (FSC), also preparing reports on supervisory convergence issues, and similarly highlights more general strategically important supervisory issues to the Economic and Financial Committee (EFC).

Publication of the work programme and other documents related to CEBS role and tasks on CEBS website should also allow European institutions, market participants and end-users to form a view on the way in which the Lamfalussy framework is being operationally implemented in the banking sector.

[2] Commission Decision of 5 November 2003, establishing the Committee of European Banking Supervisors (2004/5/EC)

[3] Council Conclusions of 2 June 2004 and of 16 November 2004.

[4] Final report of the committee of wise men on the regulation of European securities markets, Brussels, 15 February 2001.

FINANCIAL SERVICES COMMITTEE

The Financial Services Committee (FSC) was set up on 18 February 2003 by the Ecofin Council with a mandate to provide for cross-sectoral strategic reflection separate from the legislative process; to help to define the medium- and long-term strategy for financial services issues; to consider sensitive short-term issues; to assess progress and implementation; and to provide political advice and oversight on both internal issues (e.g. single market, including implementation of the Financial Services Action Plan) and external issues (e.g. WTO).

The FSC is composed of high-level representatives of the Member States (Ministries of Finance) and the European Commission (DGMarkt). The European Central Bank, and the CESR, CEBS and CEIOPS have observer status. The Committee meets in Brussels.

The secretariat of the FSC is provided by the General Secretariat of the Council. The Committee may entrust the study of specific questions to its alternate members and/or to subcommittees. Furthermore, the Committee may call upon experts to assist in its work.

The Committee reports to the Economic and Financial Committee in order to prepare advice to the Council (EcoFin), taking into account the established role of Coreper. The Chairman of the FSC is available for a regular exchange of views on strategic developments related to financial markets with the Committee on Economic and Monetary Affairs of the European Parliament.

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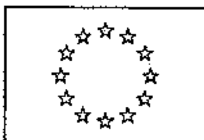

EUROPEAN COMMISSION
Internal Market and Services DG

FINANCIAL INSTITUTIONS
Banking and financial conglomerates

7/3/2007

CALL FOR TECHNICAL ADVICE (No.8) FROM THE COMMITTEE OF EUROPEAN BANKING SUPERVISORS (CEBS)

Subject: Liquidity Risk Management

1. Background

The issue of liquidity risk management is a very complex one, since it can be analysed with respect to both normal and stressed market conditions. Liquidity, or the ability to fund increases in assets and meet obligations as they come due, is crucial to the ongoing viability of any banking organisation. Therefore, managing liquidity is among the most important activities conducted by banks.

Sound liquidity management can also reduce the probability of serious problems with the institution's solvency. On the other hand, banks' capital positions can also have an impact on their ability to obtain liquidity, especially under stressed market conditions.

The importance of liquidity transcends the individual bank, since a liquidity shortfall at a single institution can have system-wide repercussions. For this reason, the analysis of liquidity requires firms' management not only to measure the liquidity position on an ongoing basis but also to examine how future funding requirements are likely to evolve under various scenarios, including adverse conditions.

In the EU, no specific prudential EU regulation in relation to liquidity risk has been adopted over the years. The Capital Requirements Directive (CRD) emphasises the need for EU credit institutions and investment firms to properly address liquidity risk through policies and procedures for management of their net funding position on an ongoing and forward-looking basis (Annex V, point 11-12, Directive 2006/48/EC). It also introduces a requirement for mandatory contingency plans to deal with liquidity crises. The CRD however, does not specify how this should be done. Moreover, according to existing EU legislation, the host supervisor is in charge of monitoring liquidity risk for branches. This allocation of responsibility for liquidity to the host supervisor dates back to 1989 (2nd Banking Directive).

The European Banking Committee ("EBC") started a long-term discussion on the future of EU supervisory arrangements in November 2005, which has focused on the challenges – regulatory and non regulatory - facing the current framework and the work that needs to be carried out. In particular, the Commission services have identified five issues

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(liquidity, crisis management, emergency liquidity assistance, deposit insurance schemes, reorganisation and winding-up of credit institutions) which deserve further consideration in order to ensure that financial stability arrangements and their interaction with prudential supervision in the EU are as efficient as possible.

The Economic and Financial Committee ("EFC") has welcomed the work being carried out in this respect by the Commission services and the EBC and has asked the Commission services to report progress on the issue of liquidity risk management in September 2007.

Work on liquidity risk management has also been undertaken in different international fora, which serves to highlight its importance in the financial stability of international financial markets.

The European Central Bank ("ECB") has started work on an analytical project aiming at assessing whether the current liquidity risk management practices in financial institutions may affect financial stability and the smooth functioning of financial institutions and markets in Europe. The ECB expects to finalise its project by February 2007.

The Basel Committee on Banking Supervision (BCBS) has recently started its own project which will be based on an analytical survey of existing national approaches, taking into account changes in financial markets as well as supervisory experience with existing regimes.

2. Specific call for technical advice

The interest of the Commission services in this topic is twofold:

(i) to promote regulatory and supervisory convergence at EU level.

(ii) consistent with the better regulation agenda, to identify those issues which may require changes in the regulatory framework, as well as further convergence of supervisory practices, and which might be discussed in the broader context of the EU financial stability and supervisory arrangements.

To feed into the above work, the Commission services are seeking the technical advice of CEBS on the issues listed below.

(a) The Groupe de Contact (GdC) conducted a stocktaking exercise in 2000 on regulatory frameworks adopted by fifteen members and three EEA countries. Nine out of eighteen countries indicated that it was their intention to change their regulatory frameworks within a relatively short period of time following the stocktaking exercise. No survey has yet been carried out on the regulatory provisions of the newer Member States, including Bulgaria and Romania.

CEBS is asked to update the GdC survey in light of market developments and to include the twelve newer Member States in this update as well as specific information regarding any different treatment provided for specific types of credit institutions and/or investment firms.

Based on the updated survey, CEBS is also asked to identify regulatory and supervisory approaches adopted in respect of branches and subsidiaries. CEBS is in

particular invited to clarify the underlying reasons and objectives that drive different supervisory approaches adopted in the EU, in relation to allocation of tasks and responsibilities for branches and subsidiaries.

(b) CEBS is asked to deepen the updated analysis set out in (a) by looking at the following issues:

- the GdC survey showed that some important variables that may significantly affect liquidity risk management have not received due consideration by supervisors. In particular collateral management, use of different types of collateral, the impact of covenants on net liquidity positions, netting agreements, the distinction between banking and trading books and the analysis of concentration of liquidity sources may be further considered in order to better align supervisory review approaches with market practices. Overall consistency with relevant existing CRD provisions (e.g. types of eligible collateral, recognition of netting arrangements) will also deserve due consideration;

- the blurring distinction between liquidity funding risk and liquidity market risk. This is, for example, due to the increased use of secured funding and, more generally, of complex products as additional sources of funding by firms (e.g. securitisation, covered bonds and structured transactions). Furthermore, assets that have been warehoused by firms to cope with stressed market conditions may not show the expected adequate liquidity profile under those same crisis scenarios;

- the increased use of internal methodologies by sophisticated firms and by credit rating agencies in order to assess and monitor firms' liquidity risk profiles;

- the impact of payment and settlements system design and relevant increased interdependencies (e.g. shorter time horizons, sound internal processes and procedures for clearing and settling outstanding transactions, quicker spillover effects of specific firm's liquidity problems).

In line with the bottom-up approach endorsed by the EBC, CEBS is asked to identify any other areas and problems that have not been included in the above and that appear not to be adequately addressed by the current regulatory framework at EU level.

This analysis will enable the European Commission to have a better understanding of the outcome delivered by a range of current liquidity regimes across the EU. It will also allow the Commission services to use this work in the broader context of the current debate on EU supervisory arrangements.

In this call for technical advice, CEBS is asked to focus on the identification of issues and not to provide technical advice on possible solutions to them. On receipt of this initial technical advice from CEBS, further calls of advice on this topic may or may not be forthcoming.

CEBS is also asked to ensure parallel work with the BCBS as much as possible, due to the global nature of the topic of liquidity risk management.

3 Timetable

CEBS is invited to provide the above advice as set out in (a) by July 2007. The analytical contribution explained in (b) above should be sent to the Commission services by January 2008.

August 2008

Mr Kieran Mooney
First Parliamentary Counsel to the Government
Office of the Attorney General
Government Buildings
Dublin 2

Re: *SECRET* - Financial Stability Contingency Planning; preparation of legislative proposals

Dear Mr Mooney

I am writing to follow-up on the Attorney General's agreement to the request of the Minister for Finance for priority drafting of legislative proposals relating to the maintenance of financial stability. The Attorney's agreement to assist in this matter is very much appreciated and I understand that you will be dealing with this matter.

The Minister's request was prompted by his conclusion, following extensive consultation with Central Bank and Financial Services Authority of Ireland and a series of consultations with and advices from the Office of the Attorney General, that a priority for financial stability contingency planning was to have ready a robust legislative proposal that the Government and Oireachtas could consider at short notice for enactment to facilitate the immediate transfer to public ownership of a specific distressed financial institution. Such a Bill would form a key component in a range of options to be available to the public authorities to assist in the maintenance of financial stability. In this context, the additional legislative modules that it would be important to be able to draw on include measures on the giving of guarantees, the issue of directions and in relation to competition legislation. The overall objective is to create a "toolkit" to provide a significantly strengthened range of tools to facilitate intervention by the public authorities to maintain financial stability.

The Attorney General's advice was received recently on draft Heads of a nationalisation bill designed to provide [redacted] The Minister is anxious to ensure that any such bill would be concise and practically orientated to provide for a swift transfer to State ownership on the basis of the minimum legislative intervention necessary. Our immediate priority is to have ready these core provisions

to enable the rapid transfer of a distressed financial institution to public ownership. In light of discussions with the CBFSAI and Advisory Counsel and the experience in the UK with the Northern Rock, the final form of this legislation may require amendment to address the specific circumstances of a particular financial institution. However, it is vital that the core provisions are advanced to the greatest extent possible at this stage as time is likely to be very limited should the legislation have to be enacted.

I have accordingly enclosed Heads of the Nationalisation Bill that have been revised in light of the Attorney's advice of 21 July 2008 and further input from the CBFSAI. Given the Minister's concern that these are advanced as quickly as possible I would appreciate if you could give an early indication of how quickly they can be progressed. In addition, draft Heads dealing with provision of guarantees and amendment of competition legislation are enclosed for drafting; these could be included with a Nationalisation Bill, or enacted separately.

In obtaining the advice of Advisory Counsel we had a number of meetings in addition to exchange of formal minutes and we are of course available to discuss these Heads with you as you require. In that regard you might contact either me at [redacted] or my colleague Kevin Nolan at [redacted]

Yours sincerely

Michael Manley
Principal Officer

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.

3 October 2007

CBFSAI assessment of financial market developments

The interbank lending rate remains high

In the eurozone area, the interest rate for interbank lending remains significantly higher than the base interest rate of 4 per cent, although the spread has narrowed slightly in recent days and there are signs of recovery in the market. The narrowing has been more significant in the sterling and dollar markets. The results released by investment bank UBS and Credit Suisse were consistent with market expectations. This has eased market concerns and had a positive effect on share prices. However, there remains the perception in the markets that there is a European bank that has a significant, as yet undisclosed, subprime exposure.

There are signs that the market is differentiating between institutions' likelihood of subprime exposure

There are signs that there is differentiation in the unsecured interbank market between those banks who do not or are unlikely to have subprime exposures and those that are seen as more likely to be exposed. Irish banks still have a "good name" in the market.

Irish banks' funding less dependent on short term whole sale market

Irish banks have less dependence on the short term wholesale market for their funding and have used debt securities for funding, a large proportion of which have maturities of over two years.

Wide range of assets can be used by Irish banks as collateral for loans from the ECB.

Irish banks can use a wide range of assets to borrow from the ECB, including mortgage backed promissory notes, which allow the banks to use their loan books as collateral. This was not the case in the UK, and the emergency liquidity provided to Northern Rock could be provided in Ireland as a normal liquidity operation.

Retail lending interest rates may increase if credit market difficulties continue

Retail lending rates remain unchanged, and if positive signs in the markets continue, is likely that the banks would be reluctant to increase rates. However, the longer the credit market difficulties continue, the greater the likelihood is for an increase. New customers of tracker mortgages may be charged a higher interest rate, even if the base ECB rate remains the same. Corporate loans that are linked to the Euribor (interbank) rate will have increased.

Contracts for Difference have resulted in losses for a number of high net worth individuals.

Recent losses arising from Contracts for Differences (CFD) have generally been borne by high net worth individuals. If the level of CFD business remains low it will impact on the profitability of stock-broking firms' profits as CFD have been a significant source of income for these firms. However, as the market was strong on the first half of the year annual results are still expected to be good.

10/WB/17
(5)

Speaking points on financial market developments
Government Meeting 6 November

Recent Developments

- Global financial markets remain volatile. Recent announcements of large losses by Merrill Lynch and Citgroup and the departure of the CEOs of both these banks have lead to renewed difficulties in the interbank market and falling share prices in financial institutions including Ireland. There remains uncertainty regarding the institutions that are exposed to subprime losses and this uncertainty is causing market volatility.

Interbank Markets

- The impact of the current market turmoil has been very evident in the wholesale interbank lending market; activity remains low, and interest rate remains higher than usual, particularly in the 3 month market. There remains a perception in the market that there are institutions that have a significant, as yet undisclosed, subprime exposure.
- Through November/December the usual "end-of year premium" for cash will increase costs of accessing liquidity in the interbank market and could cause further problems for credit institutions. The ECB is seeking to guard against an upward spike in wholesale interest rates and is expected to intervene as required to provide liquidity to the market.

Impact on Irish banks

- Irish bank share prices have continued to fall and have lost between 30% and 40% of their value since the start of 2007. The Irish banks' decrease in value has been greater than that of banks from other countries (making them increasingly attractive to takeover).
- The Irish banks are reporting to the CBFSAI that they are not having undue difficulty in meeting any funding requirements through the interbank market but the funding available is increasingly shorter term
- A number of Irish banks will be looking to rollover their longer term funding arrangements in early 2008. Banks are currently developing contingency arrangements for this rollover in case the wholesale liquidity market difficulties continue.

Impact of recent media coverage of Irish solicitors' financial difficulties

- The Irish banks report that there was an international reaction to the media coverage of the exposure of Irish banks to potential losses due to the property market speculation of two Irish solicitors. This sensitivity in the markets underlines the possibility for reputational damage for Ireland which could have a far greater effect than any losses suffered by individual institutions due to the solicitors' actions.

CBFSAI's Financial Stability Report

- The CBFSAI's annual Financial Stability Report is due to be published on 14 November 2007. This is a key assessment of financial stability issues for Ireland. There is likely to be strong media and public interest in the findings of the report and a

confidential briefing on this will be provided to Government by way of an Aide Memoire next week (13 November).

ECOFIN 11 July 2006

Public Finances in EMU 2006 – The first year of the revised SGP.

SPEAKING NOTE (if required)

- I welcome the message in the report that experience of the first year of the reformed Stability and Growth Pact has been broadly positive.

- I also welcome the Commission's assessment that Ireland's public finances remain strong and that the Government's fiscal targets are achievable.

- The Irish Government remains committed to sound public finances. The fiscal stance reflects the implementation of the Government's key economic and social programmes and the major infrastructural investment programme which is essential to tackle Ireland's infrastructure deficit and sustain the growth potential of the Irish economy.

- Our ***public investment***, whose rate is already amongst the highest in the EU, has now been placed on a multi-annual basis and includes a major programme of capital spending on transport and communications.

- We are also very conscious of the need to meet anticipated fiscal pressures over the long term. The National Pensions Reserve Fund now stands at almost 10% of GDP, having grown in 2005 by nearly 20%. We have initiated reforms in several pension aspects and, since the Stability Programme Update was published, we have introduced further measures to incentivise pension provision by those who need it most.

ECOFIN 11 July 2006

Public Finances in EMU 2006

STEERING NOTE

What will happen today?
The Council will consider the Commission communication on "Public Finances in EMU 2006 - the first year of the revised Stability and Growth Pact".

Public Finances in EMU 2006 presents an overview of recent budgetary developments and focuses on the first year of the reformed SGP. Two analytical sections deal with (i) the role of national fiscal rules and institutions to help Member States run sound public finances and (ii) fiscal policy in "good times" which deals with the scope for member states to step up budgetary consolidation during the current economic recovery. The issue of national fiscal rules and institutions is due to be discussed by the Council later in the year.

Commission's position
The assessment of the first year of the revised Pact is broadly positive. Reforms have improved implementation of the Excess Deficit Procedure (EDP). Country specific medium-term objectives (MTOs) have been set in line with the Pact with some more ambitious than required. Budget updates have been based on realistic forecasts. There has however been a deterioration in the structural balances of some MS. The Commission is critical of the tendency in Stability and Convergence Programme updates of back-loading of adjustment and a lack of specification of budgetary measures in certain cases. Overall, the Commission call for greater fiscal consolidation during the current "good times", as envisaged in the SGP.

Ireland's Position
We can generally support the Commission's call for a greater fiscal effort in all countries in the light of the current economic recovery in the EU as a whole. We have no objections to the draft Council conclusions (Appendix 1).

The *Ireland fiche* is broadly positive. The Commission expect Ireland's public finances to remain strong over the forecast period and our Stability Programme targets are regarded as achievable. The spring forecast was that Ireland would record a surplus of 0.1% of GDP for 2006. Recent data has resulted in the Commission revising the projected surplus to 0.5% of GDP, due to buoyant domestic demand and solid revenue growth. The structural balance is forecast to deteriorate by about ¾% in 2006 reflecting what the Commission see as an expansionary fiscal stance in the current year. For 2007, the Commission's Spring forecast is a deficit of 0.4% which is broadly in line with our SPU. The debt level is projected to remain on a modest downward trend to 27.0% of GDP. The Ireland fiche acknowledges that debt reduction would be even more significant but for the acquisition of assets by the National Pension Reserve Fund.

ECOFIN 11 July 2006

Public Finances in EMU 2006

BACKGROUND NOTE

1. Recent budgetary developments and prospects

In 2005, the nominal deficit in the EU was reduced to 2.3% of GDP, down from 2.6% of GDP in 2004. The structural balance improved by about 0.75% of GDP, the largest improvement since 1997. In the euro area, the deficit fell by 0.4% to 2.4% of GDP.

The deficit reduction is attributed to higher than expected growth, better revenues and strengthened policy implementation. The better than expected outturn was relatively broadly based although more pronounced in Germany, Spain, the Netherlands and Ireland.

In the spring forecasts the general government deficit is forecast to remain relatively unchanged in 2006. In 2007, the euro area deficit is expected to improve slightly to 2.3% mainly due to budgetary consolidation plans in Germany. The outlook for the general government balance in the EU as a whole is broadly similar. The up to date position on each of the countries in excess deficit is provided in Appendix 2.

After increasing in 2005 for a second consecutive year, the debt ratio in the EU is forecast to fall from 63.4% of GDP in 2005 to below 63% in 2007 due to a combination of stronger economic growth and a stable primary surplus.

EU-25

	2004	2005	2006	2007
GDP (%)	2.4	1.6	2.3	2.2
GGB (% of GDP)	-2.6	-2.3	-2.3	-2.2
Debt (% of GDP)	62.4	63.4	63.2	62.9

Euro area

	2004	2005	2006	2007
GDP (%)	2.0	1.3	2.1	1.8
GGB (% of GDP)	-2.8	-2.4	-2.4	-2.3
Debt (% of GDP)	69.8	70.8	70.5	70.1

Source: Commission Spring Forecasts 2006.

2. Commission's assessment of implementation of SGP reform

Overall, the 2005 reform strengthened the role of the SGP in the budgetary co-ordination process in promoting a high degree of macroeconomic stability, an essential condition for sustained economic and employment growth, as reflected in the Lisbon Integrated Guidelines for Growth and Jobs.

The Commission consider that the increased focus on *long-term sustainability* issues envisaged in the SGP reform has been reflected in the 2005 Stability and Convergence Programmes.

The assessment of the functioning of *the preventive arm* of the pact is mixed. On the positive side

- Differentiated medium-term objectives (MTOs) have been set with a clear link to sustainability and country specific circumstances.
- There is a greater commitment to realistic macroeconomic assumptions.
- There is a reduction in the use of one-off measures.

On the negative side,

- The structural fiscal adjustment planned for 2006 by MS not yet at their MTO falls short of the agreed 0.5% GDP
- It is not yet clear whether fiscal consolidation will be stepped up in line with the improving growth prospects.
- In some MS, the projected adjustment is back-loaded and not underpinned by concrete measures.
- According to the spring forecasts, on average the structural balance for the EU will not improve and for some MS will deteriorate, turning the fiscal stance expansionary and pro-cyclical. Rigorous budgetary implementation and, if necessary, additional consolidation measures in 2006 together with ambitious fiscal policy plans for 2007 are needed in order to reduce the gap between actual efforts and requirements under the SGP.

The experience with *the excess deficit procedure* is regarded as generally positive,

- An increased focus on structural fiscal consolidation efforts rather than just short-term nominal results.
- Increased emphasis on the need to reduce debt
- Consideration by the Commission of all relevant developments
- The increased room for judgement has been used to set realistic deadlines while ensuring that significant fiscal efforts are made
- The SGP reform has stimulated a constructive and transparent policy dialogue at EU level on the individual country cases.

A summary of the main features of the SGP reform is at Appendix 2.

3. Assessment of Ireland's Performance

The Ireland fiche is broadly positive. Overall, the public finances remain strong notwithstanding macroeconomic risks notably related to the housing sector and sensitivities to changes in the global economic environment which, if realised, would result in a larger than forecast deficit.

2005:

The general government balance posted a surplus of 1% of GDP in 2005 compared with the targeted deficit of 0.8% of GDP. This better-than-expected outturn was due to an increase in tax revenues, notably driven by buoyant capital taxes and stamp duties.

2006:

On the revenue side, the main Budget measures included a widening of the standard rate band and an increase in employee and personal tax credits (-0.5% of GDP) and the termination of some (in particular property based) tax reliefs (0.1% of GDP

approx.). On the expenditure side, there were notable increases in social welfare benefit rates (0.7% of GDP) and a significant rise in capital spending especially on transport infrastructure (0.2% of GDP) and a five-year childcare package (0.2% of GDP approx.)

A deficit of 0.6% of GDP was projected at Budget time, and this was updated to 0.3% in the April EDP notifications to take account of increasing revenues. Commission projects a surplus of 0.1% in 2006 in line with its forecast of buoyant domestic demand and revenue growth.

The Commission forecast a deterioration of around 0.75% of GDP in the structural balance in 2006 indicating an expansionary fiscal stance.

2007:
The Commission forecast a deficit of 0.4% of GDP in 2007 which is broadly in line with the Stability Programme projections.

Debt:
The government debt ratio is projected to remain broadly stable in 2006-2007 at around 27% of GDP. In the absence of the National Pensions Reserve Fund the gross debt ratio would be falling over the period to end 2007 as the accumulation of outside financial assets by the Fund prevents a quicker fall in the debt.

	Spring Forecast		**Stability Programme**	
	2006	2007	2006	2007
GDP (%)	4.9	5.1	4.8	5.0
GGB	0.1	-0.4	-0.6	-0.8
Structural balance	1.1	0.8	0.2	0.1
Debt	27.2	27.0	28.0	28.2

4. Developments in EU budgetary surveillance
The Commission has responded to the discrepancy between budgetary plans and outcomes by increasingly focusing its assessment on the credibility of the budgetary adjustment path, and by assessing Member States' fiscal policies more comprehensively over time, thereby taking greater account of aspects relating to the long-term sustainability and quality of public finances.

The Commission's assessment of the 2005 stability and convergence programmes, focused on the structural balance as the yardstick of fiscal adjustment. It is particularly critical of the back-loading of fiscal adjustment and the fact that the corrective measures are not specified in many cases. The Commission consider that member states have not been taking advantage of the current recovery to tighten the fiscal stance.

The reference to the fiscal effort required of MS which have not yet achieved their MTO is to Belgium, Luxembourg and Austria[1]. The 2006 fiscal targets are also considered at risk, to varying degrees, in Greece, France, Italy and Portugal (i.e the eurozone countries in EDP other than Germany). In each case, the Commission

[1] Budgetary Developments in 2006 and Prospects for 2007 in the euro area. ECFIN(2006) REP/52855, 17 May 2006 - table 4.2, page 16.

consider that the 2007 target is achievable but only with a (very) significant adjustment effort. For this reason, they are focusing now on member states' budgetary proposals for 2007.

5. Ireland's position

Ireland has consistently supported the operation of the Stability and Growth Pact. The formulation of medium-term budgetary policy in accordance with the SGP is in line with the Government objectives for employment, prosperity and balanced economic development.

Ireland's budgetary policy is well aligned with the SGP and the Commission's Integrated Guidelines for Growth and Jobs - as evidenced by

- The move back towards a sustainable level of annual growth as reflected in the projected average growth rates of 4.9% and 4.6% in GDP and GNP terms over 2006-2008.
- The prioritisation of productive investment through the multi-annual capital envelopes, with the objective of maintaining capital investment at almost 5% of GNP (almost twice the EU average);
- Timely anticipation of the costs of ageing by the setting aside of 1% of GNP each year for the National Pensions Reserve Fund;
- A modest debt-to-GDP ratio which is being maintained at the second lowest in the euro area – around 27% for the period 2006-2008
- Meaningful social partnership – Government has successfully promoted appropriate wage developments and consensus on economic and social priorities.

Ireland's Stability Programme Update for 2005 received a favourable Council Opinion –"a good example of fiscal policies in compliance with the Stability and Growth Pact".

6. Appendices

1. Draft Council Conclusions

2. Summary of SGP reforms

3. Note on analytical sections of Public Finances Report – fiscal rules and fiscal councils.

4. Update on EDP countries.

ECOFIN 11 July 2006

Public Finances in EMU 2006

DRAFT PRESS POINTS

- Ministers discussed the budgetary developments in the EU in light of the revised Stability and Growth Pact.

- Ministers were satisfied that the revised SGP has had broadly positive results. There was a larger than expected deficit reduction in the EU as a whole in 2005.

- However, it was recognised that budgetary plans in some Member States need to be implemented with rigour, to ensure that a satisfactory pace of budgetary consolidation is achieved especially in light of the favourable economic environment.

- Ministers also emphasised the importance of the sustainability of public finances in the face of ageing populations and called on Member States to put this issue at the heart of fiscal policy making.

ECOFIN 11 July 2006

Public Finances in EMU 2006

COMPOSITE INTRODUCTORY NOTE

The Council will discuss the Commission Communication on "Public Finances in the EMU 2006 – the first year of the revised Stability and Growth Pact". This report presents an overview of recent budgetary developments in the EU in light of the revised SGP. The report also focuses on possible challenges facing Member States including the sustainability of public finances, the avoidance of pro-cyclical policies and the importance of national fiscal rules and institutions.

APPENDIX 1

The first year of the revised Stability and Growth Pact

Draft Council Conclusions

One year after the reform of the Stability and Growth Pact (SGP), and on the basis of the Commission's Communication on Public Finances in EMU, the Council discussed the implementation of the revised SGP. Ministers also exchanged views on the execution of the 2006 budgets and preparations of budgetary plans for 2007. They agreed to come back later this year to the role national fiscal rules and institutions can play to facilitate budgetary consolidation strategies as well as to help avoid pro-cyclical policies.

Overall, the first-year's experience with the revised SGP can be judged as positive. While remaining a rules-based system, the reformed SGP has stimulated a constructive and transparent economic policy dialogue at EU level on the individual country cases, allowing the Council to reach unanimous agreement on all proposals put forward by the Commission under the revised rules of the Pact.

Budgetary adjustment in the EU has resumed and budgetary positions in 2005 have improved in structural terms by 0.8% of GDP, both in the EU and in the euro area. Medium-term budgetary objectives (MTO) have been differentiated for individual Member States in line with the agreed principles; in some cases, MTOs are more ambitious than required by the SGP. However, some Member States must pursue and step up efforts to reach their medium-term budgetary objectives. In many cases, the adjustment needs to be more frontloaded and underpinned by concrete measures

In 2006, the economic situation is improving. It is essential to take advantage of this benign economic environment to pursue and step up fiscal consolidation efforts. The long-term fiscal sustainability challenges stemming from ageing populations should be at the heart of policy making. Against this background, Member States should implement 2006 budgets with rigour and, when preparing their 2007 budgets, maintain or speed up the pace of deficit and debt reduction and avoid pro-cyclical fiscal policies. Member States in excessive deficit procedure are committed to put an end to the excessive deficit, fully complying with the Council recommendations. Member States of the euro area and of the ERM II that have not yet reached their MTO reaffirm their commitment to achieve, as a benchmark, an annual structural adjustment of 0.5% of GDP net of one-off measures.

APPENDIX 2

The Stability and Growth Pact (SGP) Reform – March 2005

The European Council endorsed changes to improve the operation of the Pact in March 2005 which impacted on both the preventive and corrective arms and made recommendations for improving fiscal and statistical governance at both the EU and the national level. Overall, there is now more room for economic judgement in the fiscal surveillance procedure and in the assessment of individual country cases. The basic requirement to comply with the reference values of 3% of GDP for the general government deficit and 60% of GDP for gross government debt continues to apply.

- The Medium Term Objective of budgetary policy of "close to balance or in surplus" is now differentiated to take account of the varied economic and budgetary circumstances across Member States.
- More flexibility allowed for countries experiencing prolonged economic downturns to consolidate their budgets over a longer timeframe, with a presumption of consolidating public finances during favourable economic periods.
- Includes incentives for Member States to carry out structural reforms, in line with the Lisbon strategy to promote jobs and growth.
- Permits a more comprehensive economic assessment of budgetary developments in the implementation of the EDP.
- Allows for the extension of the one-year deadline for the correction of an excessive deficit by an additional year and certain steps in the EDP to be repeated.

Structural reforms (eg pensions/healthcare reform or labour and product market reforms) can substantially improve government accounts in the medium to long term. The 2005 SGP reform package includes provisions aimed at ensuring that the budgetary objectives of the EU fiscal framework do not clash with such structural reforms.

APPENDIX 3

Analytical sections of "Public Finances in EMU 2006"

National fiscal rules and institutions

In the discussions on the 2005 reform of the SGP, the Council emphasised the importance of strengthening fiscal governance in the Member States. It advocated that national budgetary rules should be complementary to the Member States' commitments under the SGP. The Council also underlined that domestic governance arrangements should complement the EU framework, and that national institutions could play a more prominent role in budgetary surveillance. A discussion on this topic is planned for later in the year.

The Commission paper suggests that institutional settings at national level can play an important role in containing spending and deficit biases. These settings include in particular (i) the procedural rules of the budgetary processes (ii) the numerical fiscal rules which guide or impose restraints on policy makers and (iii) the independent bodies or institutions which provide forecasts, analysis and recommendations in the area of fiscal policy.

The Commission undertook a survey of the fiscal rules and institutions in the EU 25 in the period 1990-2005. While most of the rules applied to regional and local governments are statutorily based, rules applying to the whole of the general government sector tend to be based on political agreements and commitments. The survey concluded that numerical expenditure rules lead to lower deficits. Strong fiscal rules with automatic enforcement mechanisms seem to have a larger influence on budgetary outcomes.

The Commission's survey found no significant evidence of the development of "fiscal councils" in the member states. It distinguished existing institutions which (i) provide forecasts and analysis of fiscal policy issues and (ii) institutes issuing statements and recommendations on fiscal policy. The survey concluded that delegation of the forecasting activity could address biases in macroeconomic projections. The existing institutions appear to influence public debate and policy formation. There also seems to be a perception that independent fiscal institutions have contributed to fiscal discipline.

Fiscal policy in good times

The Commission's analysis is that pro-cyclical fiscal policies have been frequent in euro-area countries in the past decades. Since the completion of EMU, budgetary correction in bad times has become less common, but there is a greater incidence of pro-cyclicality in good times and it is mainly related to expenditure. The survey acknowledges that technical issues such as the calculation of the output gap and measurement of the economic cycle are possible mitigating factors. The Commission conclude that a possible response to the pro-cyclical issue is setting up national-level rules and institutions "that permit governments to credibly commit not to surrender to the pressures to increase spending or cut taxes in good times."

The Commission consider that independent "fiscal councils" which produce macroeconomic forecasts and budgetary impact assessments could assist in the operation of medium-term expenditure and revenue rules (with particular reference to

the use of revenue windfalls or the establishment of rainy-day funds). This would support the objective under the reformed SGP of better fiscal consolidation in good times.

Comments on Analytical Sections

Ireland would be in a relatively strong position in terms of the institutional framework for fiscal policy. Budgetary policy is formulated in accordance with the SGP and a commitment to sustainable public finances. The arrangements for the control and monitoring of expenditure have been consistently updated in the context of public service modernisation. "Fiscal rules" include for example a medium-term expenditure framework and multi-annual capital budgets. Additional revenues are generally applied to improve the government balance. In relation to the fiscal council aspect, the ESRI like its European counterparts has a significant role in providing independent analysis on fiscal policy.

The findings of the Commission's survey are not surprising. As it states, ultimately all fiscal policy has a redistributive aspect and nowhere has fiscal policy been delegated.

APPENDIX 4

Budgetary Surveillance for countries under EDP

Since spring 2005, the Commission and the Council took action on six Member States subject to an EDP. The EDP for the Netherlands was abrogated in June 2005. Article 104(7) recommendations were issued for Italy in June 2005, for Portugal in September 2005 and for the UK in January 2006. In March 2006, the Council addressed a notice to Germany under Article 104(9), which has to correct its excess deficit in 2007. The Commission and the Council also decided that Hungary has not respected the recommendations which it received under Article 104(7). Since January 2006, twelve EU countries are subject to the EDP: five euro area countries (Italy, Germany, France, Greece and Portugal), the UK and six new Member States. The up to date position on each of the EDPs is set out below.

2005 Correction Deadline

FRANCE: (in EDP since January 2003; to correct excessive deficit by 2005).
Deficit of 2.9% of GDP recorded in 2005, but is forecast to increase to 3.0% and 3.1% (on a no-policy-change basis) of GDP in 2006 and 2007 respectively.
Conclusion: Although the deficit has been corrected, abrogation at this point is not an option since there is no clear evidence of a substantial correction and there are risks attached to the forecasts. The matter should be reviewed following the autumn 2006 notifications.

CYPRUS: (in EDP since July 2004; to correct excessive deficit by 2006)
Deficit of 2.4% of GDP recorded for 2005 with projections that this will fall to 2.1% in 2006.
Conclusion: The excessive deficit has been clearly corrected. The Commission is expected to adopt a recommendation with a view to a Council decision on 11 July 2006 to abrogate the July 2004 decision.

2006 Correction Deadline (financial year 2006/2007 for UK)

GREECE: (in EDP since July 2004; to correct excessive deficit by 2006)
Deficit for 2005 was 4.5% of GDP and is projected to fall to 3.0% of GDP in 2006. The structural improvement is in line with the Council notice, but the deficit falls to 3% of GDP only because of significant one-offs (0.6% of GDP). In 2007, unless further consolidation measures are introduced, the deficit is forecast to rise to 3.6%.
Conclusion: There is no reason to act now. If the autumn 2006 forecast shows a deficit above 3% of GDP in 2006 and/or 2007, a repetition of the Council notice might be considered provided that the improvement in the structural balance required in the notice for 2006 (of at least 0.6% of GDP) is secured.

MALTA: (in EDP since July 2004; to correct excessive deficit by 2006)
Recorded a deficit of 3.3% of GDP in 2005 and this is set to fall to 2.9% in 2006.
Conclusion: While **Malta** seems to be on track to correct the excessive deficit in 2006, the spring forecasts envisage it increasing to 3.2% in 2007.

UK: (in EDP since January 2006; to correct excessive deficit by March 2007)
EDP was initiated by the Council in January following deficit figures of 3.3% of GDP for the financial year 04/05. The Commission forecast that this will fall to 3.0% in

06/07 and the structural improvement appears to be in line with the Council recommendation.
Conclusions: Action taken so far seems sufficient to ensure "adequate progress" overall towards the correction of the excessive deficit. However, there is zero margin below the reference value in financial year 2006/07 and there are several risks to achieving the budgetary targets. A further Commission assessment is due after the 24 July 2006 deadline for taking effective action.

2007 Correction Deadline
GERMANY: (in EDP since January 2003; to correct excessive deficit by 2007)
Following non-compliance with the 2005 correction of the excessive deficit, and taking account of the policy proposals of the new government, the Council agreed in March of this year that the deadline should be extended to 2007.
Germany recorded a deficit of 3.3% of GDP in 2005. Deficit forecast to fall to 3.1% in 2006 and 2.5% of GDP in 2007. However, the structural improvement falls short of the 1% of GDP recommended by the Council.
Conclusion: On the basis of currently available information, action taken so far seems sufficient to ensure "adequate progress" towards the correction of the excessive deficit according to the Council recommendations. A further assessment is due after Germany submit an update report on 14 July 2006.

ITALY: (in EDP since July 2005; to correct excessive deficit by 2007)
Italy recorded a deficit of 4.1% of GDP in 2005. The Commission's spring forecasts put the deficit at 4.1% of GDP in 2006 followed by an increase to 4.5% in 2007.
Conclusion: The forecast confirms the significant uncertainties surrounding the correction of the excessive deficit by 2007 highlighted in the March 2006 Commission communication. In the coming months, close monitoring by the Commission and Council will be necessary to decide whether a stepping up of the procedure (leading to a Council notice under Article 104(9)) may be required.

POLAND: (in EDP since July 2004; to correct excessive deficit by 2007)
Deficit of 2.5% of GDP recorded in 2005 but the Commission forecast that this will rise to 3.0% of GDP in 2006 and 2007. However, after the implementation of the Eurostat decision (by spring 2007) on the classification of funded pension schemes, the deficit figures will be revised upwards by 2% of GDP.
Conclusion: As it is unlikely that Poland will correct the deficit by the Council deadline, it is likely that the Commission will review the matter later in the year and may propose further measures under the EDP.

SLOVAKIA: (in EDP since July 2004; to correct excessive deficit by 2007)
Recorded a deficit of 2.9% of GDP in 2005 which is projected to fall further to 2.7% and 2.1% of GDP in 2006 and 2007 respectively. However, after the implementation of the Eurostat decision (by spring 2007) on the classification of funded pension schemes, the deficit figures will be revised upwards by 1.25% of GDP.
Conclusion: No steps under the EDP required for this year however a stronger fiscal effort will be needed in 2007.

2008 Correction Deadline
CZECH REPUBLIC: (in EDP since July 2004; to correct excessive deficit by 2008)

Deficit of 2.6% of GDP recorded in 2005 and the Commission forecast that it will be 3.2% and 3.4% of GDP in 2006 and 2007 respectively.
Conclusion: No further steps necessary at this stage, however, a stronger fiscal effort would be appropriate in the next few years.

HUNGARY: (in EDP since July 2004; to correct excessive deficit by 2008)
Conclusion: Recorded a deficit of 6.1% of GDP in 2005. The 2005 CPU projects that the deficit will fall to 3.3% in 2007. In contrast, the Commission projects that the deficit will be 7.0% in 2007.
Conclusion: The correction of the excessive deficit is not on track and the spring forecast shows a significant loosening of fiscal policy. The Council adopted a decision in November 2005 establishing that the action taken by Hungary in response to its recommendation was proving to be inadequate. It is likely that the Commission will propose a new recommendation later this year.

PORTUGAL: (in EDP since September 2005; to correct excessive deficit by 2008)
Deficit of 6.0% of GDP recorded in 2005 which largely reflects the decision to discontinue the use of one-off measures in the budget. The Commission forecast the deficit to fall to 5.0% and 4.9% of GDP over the next two years which is well above the targets set by the Council in its recommendation under Article 104(7).
Conclusion: In June 2006, the Commission issued an assessment of progress towards the correction of the excessive deficit according to the Council recommendations following the expiry of the deadline for taking effective action (19 March 2006). The assessment confirms the position in the spring forecasts that, although considerable progress is being made, significant uncertainties remain and the situation needs to be closely monitored.

(29)

Note for the Minister's Information on financial market developments for Government meeting of 3 September 2008

Overview

International Situation

- Financial market conditions remain extremely difficult and the international financial sector remains under significant stress with credit availability restricted, the cost of funds elevated and little immediate prospect of markets returning to their pre-crisis levels.
- There are few real indications that any sustained improvement will be achieved for some time. The more optimistic commentaries characterise the current position as 'the end of the beginning'.
- The concerns that led to the credit markets seizing-up last August persist and there is evidence that in the US the delinquency problems that affected sub prime loans are spreading to the prime loan sector.
- Major financial institutions continue to disclose major write-downs and the IMF has estimated eventual losses at $1 trillion.
- International initiatives and in particular the activities of the FED and the ECB/Eurosystem have helped to stabilise financial market conditions at particular junctures. However, recent comments suggesting clarification (?) of the criteria relating to collateral pledged when drawing liquidity from the ECB and the prospect of major international banks having to roll-over an estimated $800 million in finance over the next few months have added to the negative picture.
- International efforts to resolve the crisis (e.g. by promoting increased transparency or clearer approaches to the valuation of problematic assets held by banks) have yet to be finalised and will in any event take some time to bear fruit.

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Irish Financial System

- As reiterated by the Governor of the Central Bank on 10 July, Irish banks meet all the conventional measures of financial health – solvency, liquidity, profitability, asset quality. Their strong performance over recent years leaves them well-placed to deal with the current difficult financial market environment.
- However, Irish banks are subject to specific pressures and stresses – over and above those applying more generally internationally – owing to wide-spread international concern regarding their exposure to the property market.
- Though having very limited direct exposure to US sub-prime lending, Ireland cannot hope to completely escape the impact of international developments. The tightening and increased cost of credit, which has coincided with a significant correction in construction activity, has thrown into sharp relief the fairly significant reliance of domestic retail banks on wholesale financial markets to finance mortgage and property lending.
- There is little international investor appetite for investment in Irish financial institutions, which are perceived to be vulnerable to the real economy impacts of the credit crisis and correction in construction activity. The resulting very significant fall in the share prices of Irish financials has outpaced those in other countries. The decline in the ISEQ financial index since Q2 2007 is 69% as

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against falls of 44% in the UK FTSE and 47% in the US Dow Jones financial indices.

- Another indicator of investors' negative view of Ireland is that the yield spread of Irish Government Bonds over German Government Bonds now stands at 47bps whereas before the financial market turmoil Ireland was normally at the low end of a 5 to 10 bp range over Germany.
- In circumstances, where the financial system finds it more difficult to, access funds from the wholesale market, the only viable commercial strategy is to significantly restrict their lending activities. Retrenched lending has the obvious potential to impact adversely on the economy.

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Conclusion

The **international financial market background** is one of major losses from sub-prime mortgage products, the collapse/rescue of major banks and the prospect of further difficulties. Irish banks have weathered international developments and the correction in domestic construction activity and property prices, but are under ongoing pressure. Credit continues to be scarce and expensive, putting pressure on institutions to fund their activities with varying level of stress in different institutions.

The Irish banks continue to state they are open for business. However, the **Private Sector Credit** annual rate of increase in July was 13.3% - the lowest annual growth rate since July 2002, although reasonably high by international standards. The Central Bank said on 29 August that the annual growth of Irish residential mortgages, inclusive of securitised residential mortgages, dropped 9.6% in July. The last time the annual rate of increase in such mortgages was in single figures was at December 1987.

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Key to sustaining the position of Irish banks this far has been the **maintenance of confidence**. The strong endorsement of the position of the Irish banks in terms of capitalisation, liquidity, etc., by the Central Bank, IMF and OECD has been helpful. However, maintaining confidence is vital and challenging and the banks have indicated they would not wish any action by Government that might be interpreted in financial markets as an indication of perceived weaknesses.

The foregoing assessment underlines the importance of the **Government's role** in maintaining confidence and providing a stable economic and financial climate through sound management of the economy, prudent budgetary policies and a focus on labour cost competitiveness.

The CBFSAI continues to monitor developments closely and the Domestic Standing Group (DSG) on Financial Stability is continuing to meet to coordinate information exchanges between the Central Bank, the Financial Regulator and the Department.

A more detailed note is attached.

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Financial Market Developments

International

International financial markets remain depressed reflected in very significant falls in bank share prices, little investor interest in financial markets and continuing elevated interest rates in the euro area and constrained liquidity. The generally held expectation is that the dislocation in financial markets, which has already spilled over into the real economy, will continue for at least another year. Over the last twelve months markets have received a succession of bad news:

- **US Sub-Prime** crisis is now estimated by the IMF to be likely to reach $1 trillion in losses (approx $500 million already written off) which has massively impacted major international financial institutions which have had to bring these losses to book (e.g. UBS, Citibank, Lehmans, etc.).

- Standard & Poor reported on 22 August that that **mortgage delinquency rates** on many better quality US mortgages in July outpaced those on the sub prime loans that helped to spark the housing crisis. Total delinquencies on two categories of prime loans rose at rates of 7% and 9% from June while the rate for sub prime loans rose by 7%.

- In the US, **Fannie Mae and Freddie Mac**[1], which together own or guarantee $5.3 trillion in US mortgages (almost half of the US mortgage market) have been badly damaged by increased mortgage default. Because of the losses from the worsening situation in the US housing market both companies have sought to raise funds but investors fear they may not be able to raise enough to cover liabilities as they have to pay out if homeowners cannot meet their mortgage repayments. This has led to recent heightened speculation that Freddie & Fannie would be nationalised. In light of the Bear Stearns events in March, the market is waiting to see how they will be recapitalised and how this might impact on their share holders. The US Treasury Secretary announced in mid July that the US Government's primary focus was supporting the two firms in their current form, but continuing deterioration in underlying mortgages is focusing speculation that both will have to be rescued by the Federal authorities (re-nationalisation). [Investors may have been somewhat reassured in recent days by the successful sales of short-term debt by the two companies.]

- In Europe, **severe difficulties for certain banks**, leading to the nationalisation of Northern Rock in the UK, rescue of SachsenLB and IKB in Germany by other German banks and most recently the takeover of Roskilde bank in Denmark by a combination of the Central Bank and other Danish banks have left investors with little appetite for the financial sector.

- **Euribor rates -** The interest rates in the interbank money market remain elevated, with the Euribor 3-month rate 0.718% above the ECB base rate of 4.25% at 4.965%. The spread between this rate and the Eonia rate indicates how much of the spread of the Euribor above the base rate is due to the market turmoil. This spread

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[1] Federal Home Loan Mortgage Association (Fannie Mae) and Federal National Mortgage Association (Freddie Mae) - originally established as Federal authorities to ensure funding to mortgage lenders through the secondary mortgage market, but subsequently privatised.

was approximately 0.6% at the start of August 2008. This is lower than its peak of 0.9% during this market dislocation, but far higher than the spread of only 0.07% before the onset of the turmoil in August 2007.

Against the background of persistent bad news, markets have recently been contemplating two prospective concerns:

- A key stabilising influence over the last twelve months has been **additional liquidity** made available by international central banks (ECB, Federal Reserve, Bank of England and Swiss Central Bank). However, recent public comments by the President and members of the ECB that banks must make greater efforts to return financial markets to some form of normality has led to speculation that such liquidity will become less available as the ECB tightens its lending criteria [2]. This would lead to greater pressure on banks, particularly smaller banks where these are perceived to be otherwise vulnerable (e.g. exposed to property markets) to find finance at an acceptable price.

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- **Banks' funding requirements:** It is estimated that financial institutions will have to pay off almost $800 billion in floating-rate notes (securities used to borrow money) and other medium-term obligations before the end of 2009, i.e. either find replacement funding in this amount or realise assets to pay off these moneys. By the end of this year, large banks and investment houses such as Goldman Sachs Group Inc., Merrill Lynch & Co, Morgan Stanley, Wachovia Corp., and HBOS PLC must each redeem more than $5 billion in floating-rate notes. As banks compete for funds to pay off their borrowings, or sell assets to raise cash, these actions could exacerbate strains in financial markets. Banks that turn to shorter-term loans will have to renew their borrowings more frequently, increasing the risk that they won't be able to get money when they need it.

The effects of past and anticipated events are reflected in major falls in share price indices across international markets especially banks (see graph at appendix 1), increased prices for Credit Default Swaps (CDS, i.e. the price at which a guarantee of repayment of loan in the event of default by a borrower can be bought –see graph at appendix 2) and spill-over into real economies with decline in consumer confidence and economic growth.

Ireland

Irish banks had little or no direct exposure to the US sub-prime crises. However, original hopes that the consequences of those problems could be evaded if the crisis was short lived and spill-over into real economies avoided have not been realised. In the context of a general loss of confidence in the financial sector, the perceived vulnerabilities of the Irish domestic financial sector to high levels of exposure to the property and construction sector have come into sharp focus, amplified by the correction now underway in construction activity.

[2] Media reports point to increasing creativity of Banks in order to benefit from the ECB regime. The UK's Nationwide Building Society for example has announced plans to expand into Ireland to make use of the eurozone's funding opportunities. Spanish banks are reported to have scaled up their use of mortgage-backed securities to obtain funding from the ECB as they cannot find investors for these securities. All of these have been unhelpful.

- As a small banking market significantly involved in property lending particularly in the commercial sector, Irish banks have been hit hard by **negative investor sentiment.** The decline in the ISEQ financial index since Q2 2007 is 69% as against falls of 44% in the UK FTSE and 47% in the US Dow Jones financial indices.

- A further indicator of investors' negative sentiment towards Ireland is that the **yield spread of Irish Government Bonds** over German Government Bonds now stands at 47bps whereas whereas before the financial market turmoil Ireland was normally at the low end of a 5 to 10 bp range over Germany.

- The **share prices of individual financial institutions** have been highly volatile, in general the share prices of individual banks are worth about ⅓ of their price at the start of 2007, but have fallen precipitously at different times over the last year.

- Irish banks are under **pressure to maintain dividends**, with IL&P declaring a dividend of 22 cents per share for H1 2008 on an income of 12 cents per share in the same period.

- Domestic Irish banks continue to state they are open for business and are interested in proposals that offer real opportunity for added value. However, there has been a **decline in the rate of increase (?) in lending**; new mortgage lending has declined from €16.542 billion in the first six months of 2007 to €13,832 billion in the same period in 2008, a decline of 16%, Most banks have adopted more cautious lending practices (?) and require increased equity input from prospective borrowers.

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Against this background there is little international investor appetite for investment in Irish financial institutions. Goldman Sachs recently issued a report pointing to likely increased impairment of loans by Irish banks, expecting Irish lenders to write off 3pc of loans to property developers next year alone and reducing by 34pc their earnings estimates for the sector between 2008 and 2010. While the extent of write-offs is significant, it is close to the forecasts by the individual institutions and Goldman Sachs expects the three main banks Allied Irish Banks, Bank of Ireland and Anglo Irish Bank to remain profitable. All of the Irish banks have stressed they are working closely with key borrowers to monitor developments and manage financing needs. Nonetheless, the overall assessment reinforces investor reluctance to support Irish banks.

In the context of international concerns of growth in dependence by banks on liquidity from Central Banks, it should be noted that while the overall level of ECB funding availed of by banks in Ireland has increased from €39.5 bn (Dec 2007) to €44 bn (July 2008), domestic banks have reduced their dependence from €15 bn to €13 bn.

Financial Stability Report 2008

The CBFSAI's Financial Stability Report (FSR) for 2008 will be published in mid November. This arises from our membership of the European System of Central Banks which requires the ECB and national Central Banks to foster financial stability in the euro zone. The objective of the Report is to set out the CBFSAI's overall assessment of the stability of the domestic financial system; it does not relate to

monetary policy matters. The FSR provides the CBFSAI's view on the economic outlook generally and macroeconomic risks arising. It focuses on issues for the domestic financial system and its overall health. The overall conclusion of the FSR for 2007 was that the shock-absorption capacity of the banking system left it well placed to withstand pressures from possible adverse economic and sectoral developments. Clearly the extended period of dislocation in financial markets, spill-over into the global economy and correction in the construction sector will be reflected in the FSR 2008. While it is too early yet to anticipate the content of the CBFSAI's report for 2008, the Department will liaise closely with the CBFSAI to identify key issues.

August 2008

cc Secretary General, Mr Cardiff, Ms Herbert

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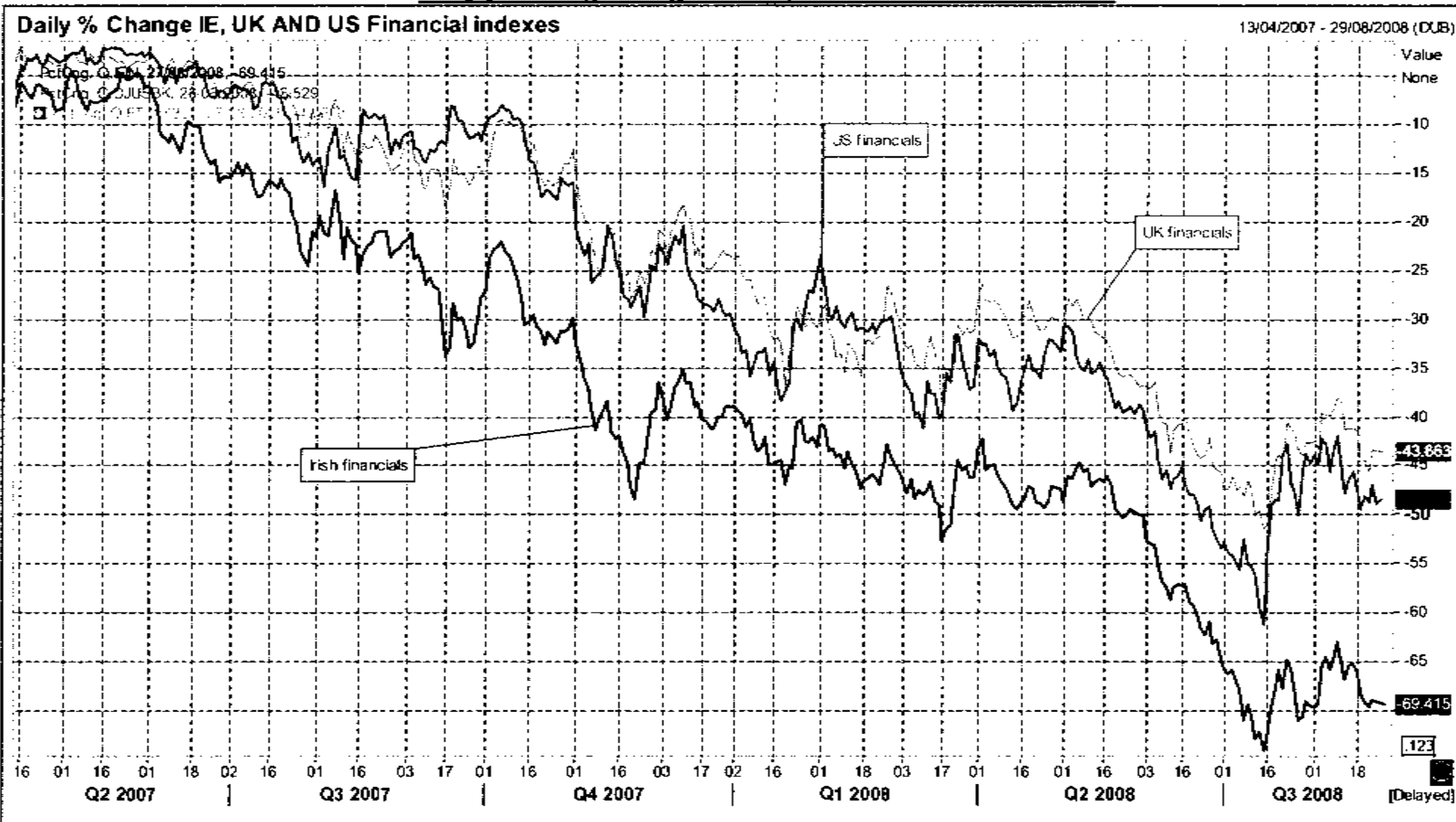
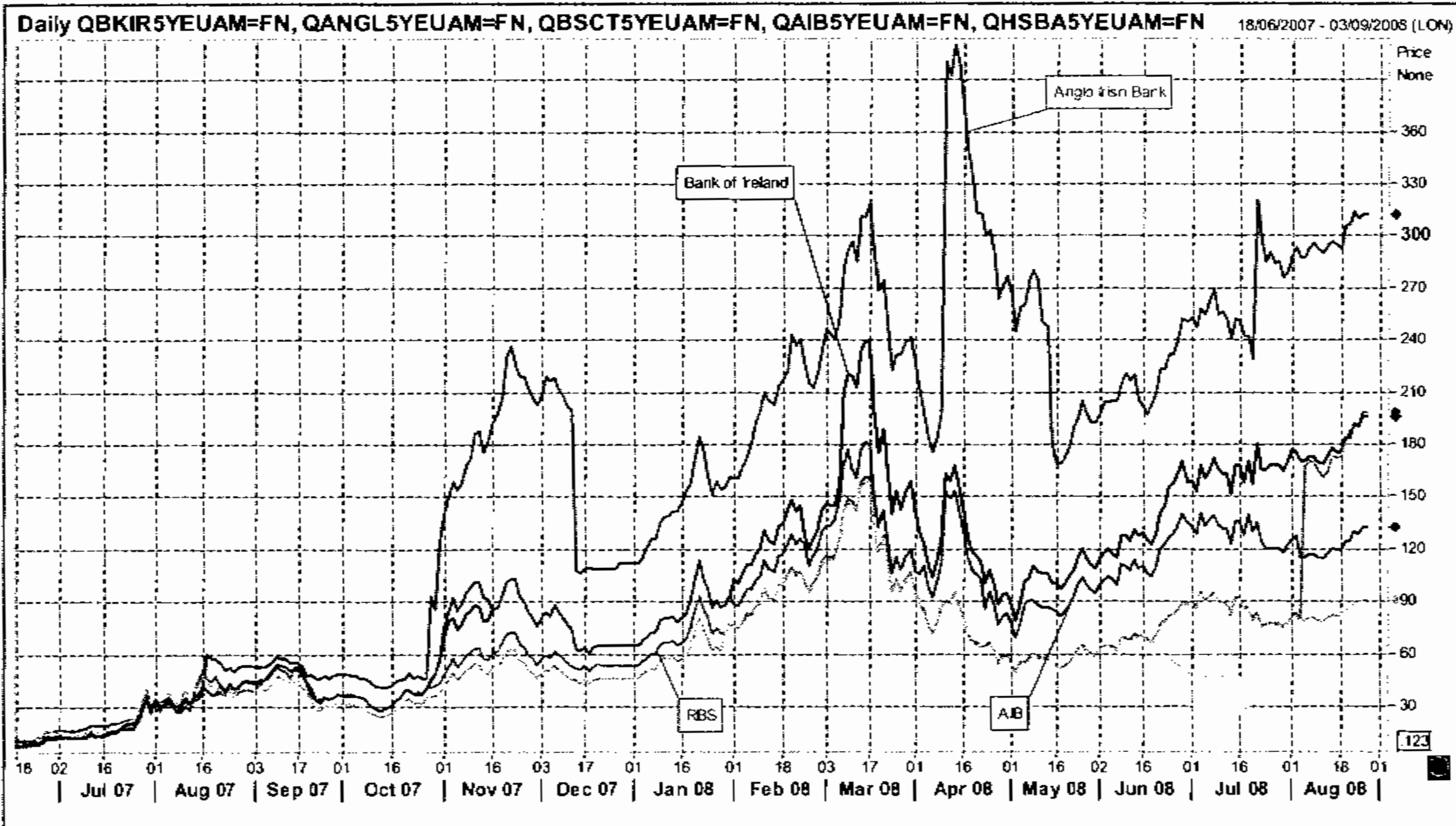
Appendix 1

Daily percentage change in Irish, UK and US financial indices



CDS spreads for AIB, Bank of Ireland, Anglo Irish Bank and HSBC and RBS



(30)

1. Mr. Beausang

2. Second Secretary
   Mr. Cardiff

Request for note on EU State Aids rules in relation to possible supports to a assist a bank with liquidity difficulties refers:

EU Treaty[1]

The EU Treaty, Article 87, sets out the basic proposition that State Assistance to any entity is not compatible with the EU treaties and is therefore not permitted, viz:

> 87 ...any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market.

The Article continues by setting out 3 instances where State Aid shall be compatible with the common market; aid having a social character, to make good damage from natural disasters, aid to certain areas of the reunified Germany; and 5 instances where aids or may be regarded as compatible with the common market; e.g., aid targeted at economic development, EU sponsored projects, etc.

Article 87(3)(b) in dealing with aid that may be compatible with the common market provides for;

> aid to promote the execution of an important project of common European interest or to remedy a serious disturbance in the economy of a Member State;

Article 88 (2) grants the Commission the primary role in deciding if Aids contravene Article 87 (The EU Court of Justice and Council also have roles) including power to "...decide that the State concerned shall abolish or alter such aid..." and (3) require "the Commission be informed in sufficient time... of any plans to grant or alter aid".

Commission Guidance

The October ECOFIN conclusions asked the Commission to clarify when a major banking crisis could be considered by the Commission to be such as to "serious disturbance in the economy" and to ensure that such decisions be expedited. The Commission responded with a paper to the February ECOFIN, which essentially contended that to focus on Article 87(3)(b) is inappropriate in that the relevant paragraph is directed at a crisis affecting the economy as a whole or at least a significant part thereof – "It follows from the foregoing that State Aid in banking crisis situations will normally not be found compatible on the basis of Article 87(3)(b)." The Commission stated that in exercising its roles in relation to State Aids, it would consider proposed aids under Article 87(3)(c) having regard to 'Community Guidelines on State Aid for Rescuing and Restructuring Firms in Difficulty' (2004/C244/02), which "...concretise the Commission's understanding of article 87(3)(c) for this type of aid".

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[1] Articles 87 to 89 set out at Appendix 1, Tab 1

Community Guidelines on State Aid for Rescuing and Restructuring Firms in Difficulty' (2004/C244/02)[2]

The guidelines apply to almost all sectors and firms[3] and are not specifically framed to meet the needs of the financial sector. It recognises that there is no Community definition of what constitutes a firm in difficulty, but states (2.1.- point 9) that "the Commission regards a firm as being in difficulty where it will almost certainly [go] ... out of business in the short or medium term" Points 10 & 11 elaborate further in an attempt to define firms in difficulty.

The Guidelines provide for a two phased process, initially Rescue Aid and subsequently Restructuring Aid

Rescue Aid, to be approved by the Commission <u>must</u> (3.1.1. – point 25)

(a) consist of liquidity support in the form of loan guarantees or loans...

(b) be warranted on the grounds of serious social difficulties and have no unduly adverse spillover effects on other Member States;

(c) be accompanied, on notification, by an undertaking given by the Member State concerned to communicate to the Commission, not later than six months after the rescue aid measure has been authorised, a restructuring plan or a liquidation plan or proof that the loan has been reimbursed in full and/or that the guarantee has been terminated; in the case of non-notified aid the Member State must communicate, no later than six months after the first implementation of a rescue aid measure, a restructuring plan or a liquidation plan or proof that the loan has been reimbursed in full and /or that the guarantee has been terminated;

(d) be restricted to the amount needed to keep the firm in business for the period during which the aid is authorised; (e) respect the condition set out in section 3.3 (one time, last time).

Provisions in relation to restructuring plans are far more detailed (points 31 to 71 of 3.2.1.) but are summarised in the Commission's notes to the February ECOFIN as requiring that the rescue plan must be feasible and coherent to address the ***Restoration of long term viability, Avoidance of undue distortions of competition*** and ***Aid limited to the minimum.***

Northern Rock[4]

The European Commission authorised, 5 December, 2007, under the EC Treaty's rules on state aid, the UK authorities' rescue package of measures to support Northern Rock, the UK mortgage bank. The Commission stated it had received full details of these measures on 26th November 2007 (also stating there had been substantial communication in advance). The Commission stated it had concluded that the measures comply with EU rules on rescue aid, but that this had no bearing on whether any future measures taken by the UK authorities to support a restructuring plan would be similarly approved.

[2] Tab 3

[3] Except coal, steel, fisheries, aquaculture, agriculture, aviation

[4] Commission Memo of 5 December on Northern rock rescue decision set out at Tab 3

In a memo appended to the statement announcing the decision, the Commission stated that the initial provision of emergency liquidity assistance by the Bank of England on 14 September, which was provided against high quality collateral, bearing a premium interest rate and without a government indemnity, was not state aid. Later measures, i.e. the deposit guarantees granted by the Treasury and further assistance provided by the Bank of England with a Treasury indemnity did qualify as state aid. The Commission stated these measures have been found to be compatible because they comply with the relevant rules for rescue aid and summarised the conditions it considered in assessing aid as rescue aid to be:

- The beneficiary has to be a firm in difficulty and it should not have received any rescue or restructuring aid during the past 10 years.
- The aid should normally consist of liquidity support and should be restricted to the minimum necessary to keep the firm in business for the rescue period.
- The aid must be granted in the form of loans or guarantees.
- The aid must be limited to a period of not more than 6 months.

If the Member State communicates to the Commission within these 6 months a restructuring plan or liquidation plan, then the rescue aid can normally continue for the time needed by the Commission to decide on this plan.

Advice of the Attorney General

REDACTED

MATERIAL

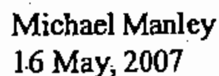
Summary

The treaty draws a wide prohibition around any aid provided through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings, it confers on the Commission the primary role in determining if any aid is contrary to the common market and it requires the Commission be notified in advance of any proposed aid.

The Commission in its paper of Feb. '08 to the ECOFIN has made clear that it does not consider banking crises can be dealt with under Article 87(3)(b), but that it will consider any proposed support to a bank in difficulty under the terms of the Rescue and Restructuring provisions issued in 2004. This effectively requires the relevant authorities to formally invoke these procedures and submit proposals for assistance to the Commission for decision. As far as can be determined, commission decisions are published.

The terms of Article 88 and point 25 of the R&R Guidelines seem to countenance there are situations where aid is provided and the Commission informed and the R&R processes invoked afterwards – though presumably this is not the intended or desired approach.

In the case of Northern Rock, the Commission decided that the provision of liquidity assistance against good quality collateral and at commercial (penal) interest rates did not constitute State aid in the rescue phase. It remains to be seen how it will view liquidity assistance to be provided under the restructuring proposal.



Michael Manley
16 May, 2007

(26)

Nolan, Kevin

From:	Manley, Michael
Sent:	07 May 2008 19:50
To:	Beausang, William
Subject:	FW: For file
Importance:	High
Sensitivity:	Confidential
Attachments:	Summary re Irish banks.doc; Briefing for Minister for Finance May, 2008.rev1.doc; Briefing on financial sector issues.doc

William,

In addition to the note for the new Minister, you asked for a short summary of key issues in relation to the principal banks/building societies, including a note in relation to the SQ group. The notes are attached, including an outline of the size of each of the institutions.

Michael

Summary re Irish banks.doc (5...

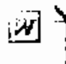
From: Manley, Michael
Sent: 07 May 2008 12:14
To: Beausang, William
Subject: FW: For file

William,

Draft note for new Minister attached.

This is based on the note you provided below, with material added in relation to periodic reports that the bottom of the credit crunch has been reached. Given its going to be a Minister new to this area, I've added material in relation to the division of responsibilities (Dept, CB and FR) and also material setting out briefly the background on the origins of the present financial stability difficulties. I'd propose to ask BEPD for a view on the Economic material.

Michael



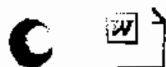
Briefing for Minister for Fina...

From: Beausang, William
Sent: 06 May 2008 14:38
To: Manley, Michael
Subject: FW: For file

My previous email refers

Taxation and Financial Services Division
Dept of Finance
Government Buildings
Upper Merrion Street
Dublin 2

From: Beausang, William
Sent: 25 April 2008 17:18
To: Manley, Michael
Subject: For file



3riefing on financial sector i...

From: Beausang, William
Sent: 06 May 2008 14:35
To: Manley, Michael
Subject: FW: We will need a note for new confidential note for new min on all the current financial stability issues and what is being done

Michael

Could you prepare a first draft of this which we can review tomorrow am. The recent note prepared for Tanaiste's meeting with some bankers might provide a good basis for this.

wb

From: Cardiff, Kevin
Sent: 06 May 2008 12:49
To: Beausang, William
Subject: We will need a note for new confidential note for new min on all the current financial stability issues and what is being done

This note contains highly confidential material relevant to the financial interests of the State, provided in confidence on the understanding it would not be disclosed other than to the Minister for Finance and /or for use in material to be provided to the Government, and under the terms of the confidential EU Memorandum of understanding on the exchange of information

Summary of key information re Irish banks

In addition to issues affecting individual banks, there are a number of generic factors impacting across all banks, but with potentially greater problems for smaller institutions:

- Virtual cessation of normal wholesale lending activity where all banks have in recent years sourced a growing share of their funding.
- Increased cost of funds and shortening of funding periods
- General negative international sentiment against Ireland and reluctance to lend to Irish banks, based on a perceived vulnerability to contraction in construction activity and property prices (IMF has pointed to a potential 30% decline in property prices)
- Contraction in lending activity (due to both decline in demand and reduced funding availability) putting pressure on profitability, potentially leading to ratings decline which in turn has the potential to affect share prices and capital adequacy.

Allied Irish Bank (figures from Annual Report December 2007 unless otherwise stated)

- One of two main universal banks in Ireland (other is BoI) – also active in UK, US and Poland
- Profits (before tax) of €2.508 bn, €1.263 in Ireland
- Market capitalisation (7 May) €12.29 Bn
- Loan book €128.716bn, of which €30.101bn are home mortgages and €46.410 are construction and property loans (Ireland €85.706 bn - €24.07 home mortgages €29.973 construction and property loans)
- Issues
  - No specific funding risks identified – funding diversified
  - No specific short selling risks identified - 1.75% of shares reported to be held on loan
  - Exposure to Irish property market – esp commercial

Bank of Ireland (figures from Annual Report March 2007 unless otherwise stated)

- One of two main universal banks in Ireland (other is AIB), also has significant UK operations.
- Profits (before tax) €1.9658 bn, €1.603 bn in Ireland
- Market Capitalisation (7 May) €9.2bn
- Loan book €125.048, of which €59.690bn are home mortgages and €26.382 are construction and property loans (Ireland €68.609 bn - €24.634 home mortgages €16.305 construction and property loans)
- Issues
  - No specific funding risks identified – 80% of funding from deposits and wholesale funding with maturity of grater than one year
  - No specific short selling or other share-related risks identified – 5.3% of shares reported to be held on loan
  - Exposure to Irish and UK property market

Anglo Irish Bank (figures from Annual Report September 2007 unless otherwise stated)

Oireachtas-p

- Smaller than AIB and BoI, focus on business banking and commercial real-estate-backed lending
- Profit (before tax) €1.243bn
- Market capitalisation (7 May) €7.3bn
- Loan book €65.949 bn 42% of loans in Ireland, 40% in UK
- Issues
  - Funding – 63% of funding base is deposits (commercial and retail), a significant proportion of deposits are understood to be in larger, potentially mobile accounts.
  - Exposure to commercial property market
  - Risk of short selling of shares by hedge funds- 12.78% of shares reported to be held on loan
  - Financial Regulator currently investigating short selling of shares in March when shares prices fell 15% in one day.

Irish Life and Permanent

- Significantly smaller than two main banks. Essentially a combination of two businesses, banking (previously Irish Permanent Building Society and Irish Permanent Building Society) and Insurance (Irish Life). Over 50% of profits contributed by insurance component.
- Profit (before tax) €448m
- Market capitalisation (7 May)
- Loan book €39.2bn, - residential mortgages €34.807bn (Ireland residential mortgages €27.310bn
- Issues
  - Key risk – currently accessing circa 20+% of funding requirement from the ECB, no sign of this improving in the near future
  - Exposure to Irish property market
  - Difficulty in accessing funding from commercial sources due to negative sentiment about the Irish property market.

Irish Nationwide (figures from Annual Report 2006 unless otherwise stated)

- Building Society
- Has been seeking to buyer which would enable it to convert from a building society to a bank, with the aim of realising gains for its 'members'. Recent offer by Icelandic bank Landsbanki rejected
- Key business is non-residential mortgage provision
- Loan book €10.4096 bn
- Issues
  - Little interest in current international market in its takeover.
  - Recently downgraded by Fitch
  - Difficulty in accessing funding from commercial sources due to negative sentiment about the Irish property market.

EBS

- Building Society
- Focus on home lending in loan portfolio
- Income (before tax) €€66.6 mn
- Loan book - €15.8822 bn – 76% home lending
- Issues
    - o Funding – 52 % total funding from customer deposits.
    - o Difficulty in accessing funding from commercial sources due to negative sentiment about the Irish property market.

Oireachtas P

Minister for Finance from .....

Note for the Minister for Finance in relation to Financial Stability Issues
7 May, 2008

This note sets out the Irish position and concerns in relation to current financial stability issues. Attached as appendices are notes dealing with: Responsibilities in relation to financial stability and Origins of current international financial stability.

Irish Financial System

Irish banks currently meet all the conventional measures of financial health - solvency, liquidity, profitability, asset quality. Their strong performance over recent years provides a good cushion to deal with the current financial market environment.

However, Irish banks cannot remain immune indefinitely to the virtual closure of money markets and are subject to specific pressures and stresses – over and above those applying more generally internationally - owing to wide-spread international concern regarding the exposure of Irish banks to the property market and in particular commercial lending. This has been demonstrated by heavy and intense speculation against Irish banks by hedge funds at times over recent months – share prices of individual banks had declined by 40-50% over the past twelve months and have been subject to particular volatility at times (e.g. share price of Irish banks fell between 5% and 15 % immediately after the announcement (17 March) of the collapse of Bear Stearns), while the share prices have recovered somewhat since, they remain significantly below their 2007 highs.

In the money markets, the price of 3 month money rose 34 basis points in March and a further 13 bp in April, such that funding is now significantly above its 'normal' price. Against a background of continuing tightening in money markets and particular concerns by international investors, the funding environment for Irish banks has disimproved further in recent weeks and there is evidence that some previously established credit lines in the US are being restricted. Notwithstanding the continuing positive statements by Government and the CBFSAI vouching for the strength of the Irish banking system, international investors are being influenced by the views expressed by some domestic commentators.

Economic Outlook

The fundamentals of the Irish economy remain relatively strong but short-term economic prospects are worsening. Several of the downside risks to our economic performance identified at Budget time have materialised including in particular:

- marked slowdown in the US economy
- sharp downturn in the Irish property market
- a strong appreciation in the Euro
- spillover into the real economy and lending from the credit crunch

The market consensus for real GDP growth in 2007 is now around 2.25%, as compared to the Budget day forecast of 3%. The deterioration in economic conditions has been reflected in tax revenue, particularly those reflecting activity in the property

market. Ireland's fiscal position and debt ratio is such that it can accommodate the impact of the changed budgetary position providing tight control is exercised over growth in current public expenditure while maintaining our programme of capital investment under the NDP.

Employment is still expected to increase this year and while unemployment has increased, the unemployment rate remains low by international standards and is below the European average.

The shift in economic conditions highlights the importance of maintaining Ireland's international competitiveness through moderate pay increase and boosting our productivity growth.

Prognosis for the International Financial Situation

Financial market conditions remain very difficult, the international financial sector remains under considerable stress and there is no reliable indicator that any sustained improvement will be achieved for some time. Reports are now occasionally appearing in the media of the 'bottom having being reached' in the present credit crunch, but these tend to be triggered by publication of economic statistics that are less bad than expected or unexpectedly good results (again less bad than expected) from individual financial institutions.

An example of such reports arose in the context of the publication of the UK's Financial Stability Report. The Bank of England, at the publication of the FSR, pointed out raising US sub-prime defaults had triggered a broad-based repricing of risk and deleveraging in credit markets. It pointed out that the adjustment to credit markets had proved more prolonged and difficult than anticipated, such that prices in some credit markets are now likely to overstate the losses that will ultimately be felt by the financial system and the economy as a whole. The Bank stated conditions should improve as market participants recognise that some assets look cheap relative to credit fundamentals. However, having made this point, the Bank of England noted sentiment remained weak[1], which had caused it to announce a special scheme to improve the liquidity position of the banking system and to increase confidence in financial markets.

Notwithstanding occasional positive reports, overall, share prices in the financial sector remain volatile, wholesale inter-bank lending is only taking place over short time horizons, and financial institutions are experiencing major difficulties in securing funding for longer time periods. A high degree of caution and conservatism and hoarding of cash is evident across the whole of the international financial sector. A number of major international financial institutions have had to rebuild their capital position owing to the scale of losses they have experienced.

[1] In the near term, tight funding conditions mean banks are vulnerable to adverse news and rumours, as highlighted by the run on Bear Stearns in mid-March, tight credit conditions can be expected to lead to a pickup in defaults among vulnerable borrowers, including some households/ parts of the commercial property sector, and financing difficulties could emerge in some emerging markets, including countries in Central and Eastern Europe with large current account deficits

In Summary:

- The concerns that initially led to credit markets seizing up last August are persisting.
- Major financial institutions continue to disclose major write downs.
- Estimates of the total losses by authoritative international bodies continue to increase.
- International initiatives and in particular the activities of the Federal Reserve and the ECB / Eurosystem have helped in important respects to stabilise financial market conditions at particular times.
- International efforts to resolve the root causes of the crisis for example by promoting increased transparency or new valuation approaches are yet to bear fruit.

Funding Position of Irish Banks

As a member of the euro area, access to normal ECB funding is a major benefit for Irish banks owing to the wide range of eligible collateral against which they can borrow funds from the Eurosystem. Irish banks have over recent months built up large reserves of ECB eligible collateral. In general, however, they have been slow to access funds from the ECB owing to the view that this would contribute to negative investor sentiment but this buffer is available to them if credit market conditions were to deteriorate further.

In circumstances that the financial system cannot access funds from the wholesale market, the only viable commercial strategy is to significantly restrict their lending activities. This is already apparent in terms of the withdrawal of particular lending products (e.g. 100% mortgages) from the market and the introduction of much tighter lending criteria. A sharp retrenchment in lending has the obvious potential to impact adversely on the economy and increases the risk of loan defaults.

The Central Bank and Financial Regulator are working closely with the domestic financial institutions to monitor their liquidity position on a weekly basis, identifying where significant funding pressures may emerge in the future.

The following points set out, in summary form, information regarding domestic financial stability planning arrangements:-

- The Central Bank is liaising with the major domestic banks at CEO level to explore the options that may be available for mutual support between the Irish banks in a crisis situation and to respond to any problem in small institutions in a collaborative fashion.

- The CEO of the Financial Regulator is meeting with the top management / boards of institutions to discuss business strategies and market-based options for dealing with difficulties that may arise in meeting funding requirements.

- The NTMA has placed some deposits with most of the main financial institutions. They are keeping this under review and will liaise with the Department and the CB/Financial Regulator as necessary.

- The NTMA is also exploring engaging in secured lending on the basis of non-ECB eligible collateral.

- The Central Bank is examining on an ongoing basis the options available to it in providing funding to Irish financial institutions.

- A standing group is in place composed of senior representatives of the Department of Finance, the Central Bank and the Financial Regulator to consider any domestic financial market issues.

EU Actions

A broad programme of actions (set out in a 'Roadmap' agreed by EU Finance Ministers in October, 2007) is being undertaken at EU level in response to financial market conditions. This includes work on improving transparency of complex financial instruments, valuation standards, the prudential framework, risk management, supervision and market functioning, including the role of credit agencies. A Memorandum of Understanding has recently been agreed at EU level dealing with the principles and arrangements for dealing with a crisis affecting any major EU cross-border bank.

7 May, 2008

cc Secretary General, K Cardiff,

Appendix 1

Background on

Responsibilities in relation to financial stability

The Minister for Finance's overall responsibilities relate to policies for maintaining macroeconomic stability, the adoption of fiscal strategies that support long term budget sustainability, and promoting a competitive and efficient market in financial services with a strong focus on the consumer.

The **Central Bank and Financial Services Authority of Ireland** is the institution charged with contributing to financial stability in Ireland, under both domestic and EU legislation. The organisation consists of two component entities: the Central Bank and the Financial Regulator, each with its own responsibilities. The roles are complementary and there is close co-operation in relation to financial stability issues:

- The **Central Bank's** statutory[2] duty specifies that "the Bank has ... the objective of contributing to the stability of the financial system"[3] Its responsibilities for financial stability relate to the surveillance of the strength and vulnerability of the overall economy and financial system (i.e. its focus is at the overall macro level).
- The **Financial Regulator's** remit includes the authorisation, prudential supervision and surveillance of the financial soundness of individual institutions (i.e. it is focused at the more micro level of individual institutions).

[2]Central Bank Act, 1942 (as amended), Section 6A(2)(a)

[3] The Central Bank is also covered by the mandate of the ESCB, which requires the European Central Bank and national central banks to contribute to financial stability in the euro area. This, therefore, requires that the Bank contributes to financial stability, both in Ireland and, as far as is practicable, elsewhere in the euro area, through its involvement in international fora.

Appendix 2

Background note on origins of current financial stability concerns

Financial markets have been in turmoil since August 2007, amid a sharp decline in investors' appetite for credit risk. The turmoil was triggered by financial losses due to defaults in the US market for sub-prime (i.e. low credit-quality) mortgages. These losses have been transmitted rapidly across the global financial system via the markets for complex financial instruments. The opacity of these instruments, combined with credit risk dispersion, made it difficult to identify the exact size and location of losses, thereby undermining investor confidence in financial markets more generally. Losses to-date by major financial institutions has been estimated at circa $300 million, with estimates of eventual losses put in a range of $500 million, to (increasingly) $1billlion. Major US and EU financial firms (E.g., Citigroup, UBS, Bear Stearns) have had major write-offs, resulting in a need for these firms to raise fresh capital form investors and Sovereign Wealth Funds, or in the case of Bear Stearns, rescue by the US Federal Authorities.

The major consequence for the Irish banking system has been the profound disruption of money markets. This has made access to funds very much more difficult, increased in the cost of funds and 'shortening' of the funding periods (i.e. funding is increasingly available only on a weekly/monthly basis as compared to previous periods of three or six months or longer). Because of the difficulties in money markets, there have been considerable interventions by major central banks into the interbank markets to restore orderly conditions by providing liquidity.

Tánaiste from William Beausang

Briefing as requested below.

If the banking sector representatives have any suggestions on how to address current funding difficulties they could be advised to communicate these to the Governor of the Central Bank and the Financial Regulator and to keep the Department informed.

Briefing on banking sector issues – 24 April 2008

Economic Outlook

The fundamentals of the Irish economy remain relatively strong but short-term economic prospects are worsening. Several of the downside risks to our economic performance identified at Budget time have materialised including in particular:

- marked slowdown in the US economy
- sharp downturn in the Irish property market
- a strong appreciation in the Euro
- spillover into the real economy and lending from the credit crunch

The market consensus for real GDP growth in 2007 is now around 2.25%, as compared to the Budget day forecast of 3%. The deterioration in economic conditions has been reflected in tax revenue, particularly those reflecting activity in the property market. Ireland's fiscal position and debt ratio is such that it can accommodate the impact of the changed budgetary position providing tight control is exercised over growth in current public expenditure while maintaining our programme of capital investment under the NDP.

Employment is still expected to increase this year and while unemployment has increased, the unemployment rate remains low by international standards and is below the European average.

The shift in economic conditions highlights the importance of maintaining Ireland's international competitiveness through moderate pay increase and boosting our productivity growth.

International Financial Situation

Financial market conditions remain very difficult and the international financial sector remains under considerable stress.

- There is no indication that any sustained improvement will be achieved for some time.
- The concerns that initially led to credit markets seizing up last August are persisting.
- Major financial institutions continue to disclose major write downs.
- Estimates of the total losses by authoritative international bodies continue to increase.

- International initiatives and in particular the activities of the Federal Reserve and the ECB / Eurosystem have helped in important respects to stabilise financial market conditions at particular times.
- International efforts to resolve the root causes of the crisis for example by promoting increased transparency or new valuation approaches are yet to bear fruit.

Wholesale inter-bank lending is only taking place over short time horizons. Financial institutions are experiencing major difficulties in securing funding for longer time periods. A high degree of caution and conservatism and hoarding of cash is evident across the whole of the international financial sector. A number of major international financial institutions have had to rebuild their capital position owing to the scale of losses they have experienced.

Irish Financial System

Irish banks meet all the conventional measures of financial health - solvency, liquidity, profitability, asset quality. Their strong performance over recent years provides a good cushion to deal with the current financial market environment.

However, Irish banks are subject to specific pressures and stresses – over and above those applying more generally internationally - owing to wide-spread international concern regarding the exposure of Irish banks to the property market and in particular commercial lending. This has been demonstrated by heavy and intense speculation against Irish banks by hedge funds at times over recent months. Over recent weeks the funding environment for Irish banks has disimproved further and there is evidence that some previously established credit lines in the US are being restricted. Notwithstanding the continuing positive statements by Government and the CBFSAI vouching for the strength of the Irish banking system, international investors are being influenced by the views expressed by some domestic commentators.

Funding Position of Irish Banks

As a member of the euro area, access to normal ECB funding is a major benefit for Irish banks owing to the wide range of eligible collateral against which they can borrow funds from the Eurosystem. Irish banks have over recent months built up large reserves of ECB eligible collateral. In general, however, they have been slow to access funds from the ECB owing to the view that this would contribute to negative investor sentiment but this buffer is available to them if credit market conditions were to deteriorate further.

In circumstances that the financial system cannot access funds from the wholesale market, the only viable commercial strategy is to significantly restrict their lending activities. This is already apparent in terms of the withdrawal of particular lending products from the market and the introduction of much tighter lending criteria. A sharp retrenchment in lending has the obvious potential to impact adversely on the economy and increases the risk of loan defaults.

The Central Bank and Financial Regulator are working closely with the domestic financial institutions to monitor their liquidity position on a weekly basis, identifying where significant funding pressures may emerge in the future.

EU Actions

A broad programme of actions is being undertaken at EU level in response to financial market conditions. This includes work on improving transparency of complex financial instruments, valuation standards, the prudential framework, risk management, supervision and market functioning, including the role of credit agencies. A Memorandum of Understanding has recently been agreed at EU level dealing with the principles and arrangements for dealing with a crisis affecting any major EU cross-border bank.

See below for summary information regarding domestic financial stability planning arrangements:-

- The Central Bank is liaising with the major domestic banks at CEO level to explore the options that may be available for mutual support between the Irish banks in a crisis situation and to respond to any problem in small institutions in a collaborative fashion.

- The CEO of the Financial Regulator will be meeting with the top management / boards of institutions to discuss business strategies and market-based options for dealing with difficulties that may arise in meeting funding requirements.

- The NTMA has placed some deposits with most of the main financial institutions. They are keeping this under review and will liaise with the Department and the CB/Financial Regulator as necessary.

- The NTMA is also exploring engaging in secured lending on the basis of non-ECB eligible collateral.

- The Central Bank is examining on an ongoing basis the options available to it in providing funding to Irish financial institutions.

- A standing group is in place composed of senior representatives of the Department of Finance, the Central Bank and the Financial Regulator to consider any domestic financial market issues.

24 April 2008

cc Secretary General, K Cardiff, G Steadman

European Union
Financial Services Committee

Brussels, 7 May 2004

NON PAPER

from :	Secretariat of the Financial Services Committee
to :	Members of the Financial Services Committee
Subject :	**EU structures for monitoring financial stability and managing financial crises**

Introduction

1. The Informal meeting of Ministers of Finance in Stresa stated that crisis management should have a high priority in the follow-up of the Brouwer reports and the evaluations of the implementation of the recommendations of these reports. In order to engage in a more in-depth examination of European measures for financial stability and crisis management, it was argued that it is important to have a distinct picture of crisis management arrangements at the national level. Therefore, as a first step, the FSC has sent out a survey asking for country specific information from the member states[1] on ongoing work by the national authorities on their arrangements for crisis management. By September 2004, the current crisis management system in the EU needs to be thoroughly assessed so that concrete policy suggestions on crisis management will be included in the considerations with respect to the future strategy for EU financial integration.

2. The interim results of the survey on national crisis management arrangements have been discussed by the EFC and reported to the 3 April informal Ecofin meeting in Puchestown. In finalizing its work, the FSC was invited to include in its final report a suggestion on how to arrange a crisis simulation exercise between all the relevant authorities.

[1] All references to member states include those countries acceding on 1 May – references are to the 25 current and acceding countries.

3. The remainder of this paper is organized as follows. First the conclusions from the FSC meeting of 16 March are discussed and extended with common national practices. Secondly the current European structures for monitoring financial stability are discussed. Subsequently the paper deals with EU structures for crisis management, contingency planning and stress tests. Finally, the paper offers a number of recommendations for the improvement of the current EU arrangements for crisis management.

The main conclusions on national arrangements

4. At the FSC meeting of 16 March 2004 members discussed the preliminary results of the survey, and came to the following conclusions with respect to national crisis arrangements:

i. A key issue for safeguarding financial stability effectively is the co-operation and exchange of information between the central bank, the (other) supervisory authorities and the Ministry of Finance at different stages and on different levels. Finance Ministries should be informed at an early stage of potential problems emerging, while fully respecting the responsibilities of the central bank and (other) supervisors.
ii. Co-operation between the relevant parties benefits from formalisation and transparency (preferences varied between Memorandum of Understanding and legislation).
iii. Although the results of the survey show that both at the national and the EU level there are no legal impediments to the full and timely exchange of information, members feel that a gap exists between theory and practice. In the absence of a well-established culture of cooperative information-sharing, the bodies involved may be reluctant to be as open as legislation permits. As a result, members feel the development of such a culture might overcome remaining obstacles.
iv. Members stress the importance of having contingency plans in place and performing crisis exercises on a regular basis. When formulating plans and performing exercises, it is useful to distinguish between different types of financial crises.

5. Table 1 gives an overview of the extent to which the principles mentioned above are already common practice in EU member states.

Table 1. Main elements of national practices

Country	Arrangements for co-operation and information exchange in place	Arrangements have been formalised	Use of contingency plans	Use of crisis simulation exercises
AT	yes	yes	no[1]	no
BE	no	no	no	no
CY	-	-	-	-
CZ	yes[2]	yes	no	no
DE	yes[3]	yes	yes	no
DK	yes	no	yes	yes
EE	yes	yes	no[4]	no
ES	no	no	no	no
FI	yes	no	yes	yes
FR	yes	yes	no	no
GR	no	no	no	no
HU	no	no	no	no
IE	no	no	yes	no[5]
IT	no	no	yes	no
LT	yes[6]	yes	no	no
LU	no	no	no	no
LV	no	no	no	no
MT	no	no	yes	no[5]
NL	yes	no	yes[7]	no
PL	no	no	yes[8]	no[9]
PT	no	no	no[10]	no
SI	-	-	-	-
SK	no	no	no	no
SV	yes	no	yes	yes
UK	yes	yes	yes	yes

1. The Ministry of Finance in co-operation with the Financial Market Authority and the Central Bank intend to set up such procedures during the course of 2004.
2. Ministry of Finance is responsible for supervision of insurance companies and pension funds; effectively this is co-operation between supervisory authorities.
3. BaFin and the Bundesbank are members of the Forum of Financial Market Supervision, while the Finance Ministry can participate.
4. The financial sector stability procedures by the Bank of Estonia for banking sector financial crisis management are under development.
5. It is intended to carry out crisis management exercises in the (near) future.
6. The Ministry of Finance, the Bank of Lithuania and the Securities Commission co-operate in the area of deposit insurance and insurance of liabilities.
7. No full-fledged contingency plan is in place; with respect to oversight on payment and securities settlement systems emergency scenarios have been developed.
8. The National Bank of Poland took steps aiming at building a comprehensive action plan in case of systemic threats in the banking sector and the process is underway.
9. Within the Insurance and Pension Funds Supervisory Commission efforts are being made to create a simulation and prognostic model which could be helpful in preventing financial crisis.
10. Banco de Portugal, the Instituto de Seguros de Portugal and the Comissão do Mercado de Valores Mobiliários are currently developing contingency plans.

6. Moreover, in the context of the first assessment of implementation of the Brouwer recommendations the Groupe de Contact (GdC) indicated that with respect to banking supervisory authorities' contingency planning tends - on the whole - to be narrowly focused on ICT (for example data back-up and recovery arrangements). Some countries however have broader forms of planning in place, including some with dedicated staff, liaison with the Finance Ministry and/or Central Bank, regular emergency exercises, and business continuity plans.

Question 1: Looking at the overview presented in table 1 and the background paper discussed at the FSC meeting of 16 March, what common practices can be distinguished? Which of these deserve to be implemented at the EU-level?

European structures for monitoring financial stability

7. Before looking at the interplay among different authorities in a European crisis situation, this section takes a closer look at the institutional arrangements in 'ordinary' times. The framework to assess the current structures consists of the following elements:

- the gathering and assessment of information, and
- co-operation and information-exchange between the relevant authorities.

Gathering and assessment of information

8. Regarding the gathering and assessment of sectoral information, the ECB has developed a systematic monitoring of the stability of the banking system in the EU area in collaboration with national central banks and prudential supervisory authorities, represented in the ESCB Banking Supervisory Committee (BSC). The main focus of activity of the BSC is the analysis of structural developments and the monitoring of potential vulnerabilities in the banking sector. The BSC also provides the forum for the exchange of relevant information between the Eurosystem and the supervisory authorities.

9. Next to that, at the request of FSC/Ecofin, CEIOPS will establish a macro-prudential surveillance programme for monitoring the interplay between insurance/pension funds and financial stability within 2005-2006, based on indicators reported by the members and observers of CEIOPS. With the development of a macro-prudential surveillance programme within CEIOPS, supervisors will be better prepared to gauge the financial sustainability of the insurance market in Europe on a regular basis, and assess any need for common supervisory measures to ensure stability in the insurance market in Europe.

Co-operation and information-exchange

10. The first assessment of the implementation of the Brouwer recommendations by the FSC concluded that within sectors, co-operation between the various national regulatory and supervisory authorities appears to work well. Bearing in mind the increasing number of cross-border activities of financial institutions, the level 3 committees will play a key role in extending this co-operation (regarding the exchange of information, supervisory convergence, best practices, etc).

11. The Brouwer report also states that cross-sectoral coordination among all EU committees (level 2 as well as level 3) on common policy issues should be promoted. Moreover, the FSC, the EFC Financial Stability Table and the meetings of the three level 3 committees (3L3) Chairs are effective fora for co-operation and exchange of information between all authorities involved in regulation and supervision of the different sectors of the financial system.

12. Currently, information exchange relies on bilateral and multilateral MoUs and protocols between central banks and supervisory authorities. These are mainly bilateral MoUs, clarifying the relationships between home and host-country supervisors, and specific MoUs for cross-border financial conglomerates, such as Dexia, Fortis and Nordea.

Other arrangements include:

- the Sienna Protocol which mainly focuses on the exchange of supervisory information and mutual assistance in case of cross-border onsite inspection of *insurance companies*,
- the Helsinki Protocol, which focuses on the co-ordination of committees with respect to the relevant cross-border *insurance group*, and
- the MoU on co-operation between *payment system overseers and banking supervisors* in Stage Three of the Monetary Union.

13. Table 2 gives an overview of the different bodies in which central banks, (other) supervisory authorities and ministries of Finance (regularly) meet and exchange information concerning financial regulation, supervision and stability.

Table 2.

	NCBs	**Supervisory Authorities**	**MoF**
NCBs	ECB/ESCB	BSC* CEBS*	EFC-FST**
Supervisory Authorities	BSC* CEBS*	BSC* CEBS* CEIOPS CESR	MTG
MoF	EFC-FST**	MTG	EFC-FST FSC EBC EIOPS

* Consists of supervisory authorities and central banks responsible for banking supervision.
* * The Chairmen of the supervisory committees can attend meetings of the EFC-FST.

Question 2: In increasingly integrated financial markets, co-operation between all authorities involved in regulation and supervision of different elements of the financial system is needed. Does the current institutional setting ensure proper co-operation between central banks, (other) supervisory authorities and ministries of Finance in 'ordinary' times?

European structures for crisis management, contingency planning and stress tests

14. For historic reasons, present institutional framework for crisis management in the EU is primarily designed to counteract disturbances in national markets. Currently, guiding principles are that the instruments of crisis resolution are available at the national level and that costs are born at the national level. Discussions in the FSC and EFC Financial Stability Table show that there is a need for clear understanding of the role of and interplay among different authorities involved in a financial crisis situation having an EU dimension.

15. The existence of a single market in financial services, including free cross-border establishment and service provision (European Passport), increases the risk of cross-border contagion. Moreover, no requirement exists for the relevant national authorities to take account of the influence of their response to a financial crisis within a cross-border financial institution on other member states or the single market itself. In order to take account of these externalities, co-operation between home and host countries with respect to crisis-management could be enhanced. The next paragraphs assess to what extend the elements mentioned in paragraph 7 are already in place with respect to EU crisis management.

Gathering and assessment of information

16. Supervisory authorities need to ensure that the management information systems of financial institutions and groups are able to generate accurate information in all times. Next to that supervisors need to be able to assess the financial position of financial institutions at a short notice in a crisis situation. Paragraph 8 and 9 show that already a lot has been achieved with respect to complementing the existing national reviews by an area-wide perspective, and work is going on to bring about a system that covers the whole EU financial system.

Information-exchange and co-operation

17. If the emergence of financial problems at a major financial group are likely to have contagion effects in other member states cooperative arrangements should be in place to ensure adequate and timely exchange of this information between the central banks, (other) supervisory authorities and ministries of Finance. Finance ministries need to be informed

about any development that might put public money at risk or have serious stability or macro-economic implications. As already indicated in paragraph 3, there are no legal impediments to the full and timely exchange of information at the EU-level. However, the previous FSC discussion showed that in the absence of a well-established culture of cooperative information-sharing, the bodies involved may be reluctant to be as open as legislation permits. Therefore, central banks, (other) supervisory authorities and ministries of Finance need to agree on practical arrangements (e.g. MoUs or protocols) that ensure an adequate exchange of information.

18. Currently, information exchange in European-wide crisis situations mainly relies on the existing bilateral and multilateral MoUs and protocols between central banks and supervisory authorities. However, these arrangements are not specifically tailored to managing a financial crisis and/or do not include all authorities potentially involved in managing a crisis in the financial system (e.g. ministries of Finance).

19. An exception is the Helsinki Protocol which also applies to emergency situations. However, this protocol does not include all authorities potentially involved in managing a crisis in the financial system (e.g. ministries of Finance). In February 2004, the Helsinki Protocol Working Group (HPWG) presented a report on crisis management in insurance groups. According to the HPWG the protocol complies with almost all essential crisis management requirements. However, the HPWG acknowledges that in preceding crisis situations the exchange of information could have been better. To further improve crisis management by supervisory authorities, the HPWG recommended that a specific emergency plan identifying the main issues to be addressed in a crisis situation and identifying the other authorities to be informed, should be developed.

20. Only one specific EU crisis management arrangement exists; the BSC MoU on high-level principles of co-operation in crisis management between *banking supervisors and central banks*. The MoU consists of a set of principles and procedures for cross-border co-operation between banking supervisors and central banks in crisis situations. These principles and procedures deal specifically with the identification of the authorities responsible for crisis management, the required flows of information between all the involved authorities and the practical conditions for sharing information at the cross-border level. The MoU also provides

for the setting-up of a logistical infrastructure to support the enhanced cross-border co-operation between authorities. However, this MoU does not include all authorities potentially involved in managing a crisis in the financial system (e.g. ministries of Finance).

21. In September 2003 the BSC organized a crisis management exercise. The main focus of the exercise was on the practical implications for banking supervisors and central banks of dealing with a crisis situation with cross-border ramifications and potential systemic implications throughout the EU. The exercise showed that the management of a financial crisis at the EU level pivots on how smoothly three main processes develop among the authorities involved, notably: (i) efficient communication and information sharing, (ii) effective co-ordination and decision-making between authorities and (iii) positive management of potential conflicts of interest with regard to each authority involved. The exercise suggested that it would be important to conduct further work in order to refine the common understanding between the authorities on how such processes may be managed and identify areas where improvement could be made.

22. Next to these pan-European arrangements, regional developments can force national authorities to set up different forms of co-operation. For example, the structure of the Nordic financial sector urged the Nordic central banks and supervisory to established a specific MoU on crisis management. In addition, the Nordic Ministries of Finance have started regular informal meetings dealing with current regulatory issues. Among other things the Nordic Ministries of Finance discuss the possibility to reach a common agreement on the principles of cost sharing with respect to official cost to be borne in case of possible cross-border financial crises.

23. The arrangements mentioned above facilitate information-exchange and co-operation between different authorities. Nonetheless, the instruments of crisis resolution are merely available at the national level and therefore the authorities still have a national mandate with respect to decision-making.

Related issues

24. At the FSC meeting of 16 March 2004 members also concluded that potential problems with respect to competition law should be addressed and the legal framework for national deposit and investor compensation schemes could be clarified.

25. The second Brouwer report discusses the competitive implications of decisions with respect to crisis management. In the field of competition policy, the EU and national regimes co-exist, but EU rules prevail over national laws. The EU framework for competition policy has been laid down in Articles 81 to 89 of the EC Treaty[2] and in a Council Regulation on the control of concentrations between undertakings (EEC/4064/89). The rules on mergers should be distinguished from those on states aid. In the Brouwer report competition authorities are called upon to maintain timely and robust procedures for considering the competitive implications of crisis management measures.

26. The deposit insurance directive prescribes the principle of 'home country control'. As a result, consumers fall under the protection of the deposit insurance system of the member state where the parent company is settled. Within the EU consumers of different branches of a single bank thus fall under the protection of the same deposit insurance system. As some member states offer a level of protection that is higher than required in the directive, these member states do not have a level playing field. The difference in the levels of protection is the logical result of the minimum harmonisation prescribed in the directive, which allows

[2] The EC Treaty, Article 87(1) declares that any state aid that distorts or threatens to distort competition is incompatible with the common market. Under this principle, a state measure qualifies as state aid if a private investor would not be willing to provide the aid under similar circumstances. In the case of liquidity support for otherwise solvent institutions, the Commission takes the view that such support does not constitute state aid, the liquidity being granted on terms which are not more favourable than the discount rate, and appropriate guarantees being provided. Article 87(3)(b) provides for a possible derogation for measures which are taken to 'remedy a serious disturbance in the economy of a Member State'. Measures to remedy a systemic crisis could therefore be deemed compatible with EU competition law if they support the whole national banking system without unduly distorting competition, and if they are limited to what is strictly necessary.

member states to provide a higher level of protection than required. However, the directive deals with the problem of the limited level playing field to an important extent, by obliging member states to offer supplementary protection to those branches that fall under the scope of a deposit insurance system with a lower level of protection.

Question 3: Which specific actions are needed in the above mentioned areas?

Conclusion and policy recommendations

27. The current management of an EU financial crisis relies on bilateral and multilateral MoUs and protocols which are not specifically tailored to managing a financial crisis and/or do not include all authorities potentially involved in managing a crisis (e.g. Ministries of Finance).

28. It is generally acknowledged that every financial crisis is unique and needs to be dealt with on a case-by-case basis. However, to ensure effective crisis management the EU arrangements must provide a structure for central banks, (other) supervisory authorities and Ministries of Finance to support:

- *EU-wide information gathering and assessment*: Paragraph 8 and 9 show that already a lot has been achieved with respect to complementing the existing national reviews by an area-wide perspective, and work is going on to bring about a system that covers the whole EU financial system.

- *Information-exchange*: Central banks, (other) supervisory authorities and ministries of Finance need to agree on practical arrangements (e.g. MoUs or protocols) that ensure an adequate exchange of information. Whether these agreements need to be based on voluntary rules or whether the agreements need to create binding obligations for information exchange in crisis situation needs to be decided.

- *Decision making in case of problems at a pan-European financial institution:* Procedures for EU decision-making between central banks, (other) supervisory authorities and ministries of Finance needs to be developed. In order to make these decision-making procedures work, it needs to be clear which crisis management tools are available, how

responsibilities are divided and how the burdens of any potential actions will be shared among the different member states involved.

29. Further work and coordination between all parties involved is needed to improve the current EU arrangements for crisis management. The FSC should appoint a rapporteur who, working transparently and in cooperation and consultations with relevant authorities, will be responsible for making proposals on how the current arrangements for crisis management at the EU-level could be improved, based on the principles set out above. The rapporteur is invited to make use of the knowledge already available at central banks, (other) supervisory authorities and ministries of Finance. In this respect, the FSC highlights the experience of the BSC with the MoU on high-level principles of co-operation in crisis management between *banking supervisors and central banks.*

30. After further developing the practical arrangements for EU crisis management, these arrangements should be tested by means of a crisis simulation exercise. The experience of the BSC shows that such an exercise could be helpful with respect to:

- the mapping of practical implications and problems with respect to cross-border co-operation;
- providing input for the refinement of contingency plans, and
- developing the authorities' preparedness for tackling a crisis at the EU level.

Therefore, the rapporteur, in cooperation with relevant authorities, is also invited to make suggestions on how a crisis simulation exercise between all relevant authorities could be arranged.

31. The rapporteur will report to the FSC at its next meeting on 9 July in order for the committee to advise, through the EFC-FST, the Ministers at their informal meeting in Scheveningen on 10-11 September 2004.

Question 4: Do members agree with the policy recommendations mentioned above?

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III. Priorities for the 2005-2006

6. Having regard to these recommendations, which complement those of previous Brouwer reports, the September 2004 EFC Financial Stability Table agreed to transmit the report of the FSC's 'rapporteur' to the September informal Ecofin meeting, and it suggested to concentrate further work in two priority areas:

- **Enhancing the cooperation and exchange of information both at the national and EU level** in a pragmatic manner while taking into account the responsibilities of the respective authorities in their to day-to-day supervision and crisis management tasks; and

- **Overcoming the challenges encountered within the current framework**, in particular by defining the role of the various authorities in different Members States, e.g. related to cost-sharing (in regard to possible public support measures: such as emergency liquidity assistance, guarantees and solvency support which may have potential budgetary implications), and taking into account the need for strict and uniform conditions for using public funds.

7. The FSC's survey[4] indicated that, at **national level,** only a few Members States have established specific arrangements for co-operation and information exchange covering all relevant authorities. Therefore, the EFC urged all Member States to **review their national arrangements** and to enhance them where needed, e.g. by creating domestic standing groups, and in this context to develop **contingency plans**. The detailed set-up of such arrangements should remain at national discretion, in line with the existing division of responsibilities between the respective authorities regarding supervisory and crisis management tasks. Nevertheless, such arrangements should ensure full and timely information exchange, and flexible co-operation with similar joint arrangements in other Member States in the case of perceived systemic problems. Moreover, supervisors and central banks are invited to further develop **stress tests**[5] and share the aggregate results with finance ministries on a periodic basis. The FSC is invited to monitor the progress in this area and report back to the FST by **September of 2005**.

8. **Memoranda of Understanding** (MoU) provide an agreed set of principles and procedures for cooperation, based on mutual trust and understanding between the

[4] The FSC conducted a survey in spring 2004.
[5] CEBS prepared a report for the 3 September EFC Financial Stability Table regarding the intentions of the Banking Supervisors in this area.

- The other key risk to growth stems from the potential unwinding of the spectacular booms in house prices and construction.

- High profitability and capitalization levels have bolstered the capacity of the domestic banking system to withstand shocks without creating systemic stress. Irish banks' profit margins remained stable in 2003 (at approximately 44 per cent) and this is partly explained by a marginal improvement in cost-income ratios (i.e. the ratio of non-interest expenses to gross income).

- Irish banks remain well capitalised with solvency ratios significantly in excess of the regulatory minimum.

Survey of national arrangements for financial stability and financial crisis management

The Informal Ecofin in Stresa (September 2003) said that crisis management should have a high priority in the follow-up of the Brouwer reports. The FSC has now carried out a survey of national crisis management and financial stability arrangements. It showed

- That arrangements for cooperation between national central banks and supervisors are good but that better arrangements need to bring Finance Ministries into the loop
- There may be a need to improve arrangements for cross-border cooperation arrangements
- It's not clear how national guarantee schemes would operate in the event of a failure of a systemically-important cross-border financial institution.

Other Initiatives

The risks associated with credit risk transfer are being studied at present. Also, insurance supervisors are cooperating in the assessment of financial stability in the insurance sector.

THEME: C1

Effectiveness of the ECOFIN and Domestic Standing Group (DSG) (Central Bank, Financial Regulator and Department of Finance)

LINE OF INQUIRY: C1b

Formulation and reaction to crisis simulation exercises

Follow up to Crisis Simulation Exercise 2007[1]

Introduction

The following note represents a summary of the feedback from the players of the Crisis Simulation Exercise (CSE) held on the 17th of December. The exercise consisted of representatives from both the CBFSAI and the Department of Finance.

Plot Outline

The plot for the crisis simulation was based round the likely default of a large commercial property loan in Ireland. The default of the commercial property loan would have implications for Alpha bank both in terms of the quality of the loan book but also the future income stream of Alpha bank. Alpha bank was modelled on an existing Irish credit institution.

While the plot, the characters and the institutions were contrived the exercise was designed to reflect one possible scenario which could develop. The fictional financial institution and system was designed to reflect the features of the Irish financial system

Purpose of the Crisis Simulation Exercise

The aim of the exercise was to test the procedures put in place by both the CBFSAI and the Department of Finance. These included an assessment of our crisis management procedures, especially:

1. The co-ordination between the three parties
2. The Functioning of the CSG in terms of an advisory forum on crisis management and the roles assigned to CSG members
3. Adequacy of, and assessment of, information that is critical to crisis management
4. Testing the use of materials in the new Black Book e.g., Crisis Management Procedures, System Impact Assessment and the communications Strategy

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[1] Compiled by Gordon Barham, FSD

Lessons learned from the Crisis simulation Exercise

Based on the criteria listed above, the following section summarises the general points offered in the feedback forms. An annex at the end of this note provides further information on the feedback broken down into CB, FR and DoF Responses.

1. **Communications channels** were highlighted as an area that requires future work. The concern surrounds the communication between DSG members as well as the role of press offices in communicating with the public.

   The DoF was concerned about the extent to which "CB" represented "FR" position in a crisis and vice versa, risk of second guessing by Department of 'political' objectives and potential for conflict of objectives that would arise between all parties

   Feedback from both the CB and FR also highlighted a need for increased communication and flow of information with the DoF

In order to ensure a balanced view it was suggested that a representative from both the CB and FR be present during meetings with the DoF.

The flow of information could also be enhanced if key information that the DoF would require was identified in advance insofar as possible. This could include information on the breakdown of deposits. It may be necessary to nominate a member of the CSG to be responsible for collating this information. However, it is worth considering the logistics of this step in light of any confidentially agreements held between the CBFSAI and regulated institutions

Focusing on the role of outside communication it might be useful to prepare templates of press releases that the DSG members could call upon in a crisis situation

2. The number of participants involved in the CSG presented **logistical issues** such as the sharing of information among the members. This led to a situation where individuals were talking among themselves rather than the CSG interacting as a single group. This led to information asymmetries and hampered the ability of the group to form a coherent view.

The suggestion is to streamline the CSG with a structure similar to the CBFSAI organisation. Each area – Prudential, Operations, Financial Stability/Economics etc. would take responsibility for their area of analysis. Each area would be

responsible for offering their view of the systemic nature of the affected institution(s). The head of Financial Stability would be responsible for collating these high level views only.

3. **Prioritisation of Information** It was felt that the members of the Crisis Steering Group (CSG) were required to process too much information in a relatively short period of time. Given the flow of information, participants found it difficult to assimilate information and in turn it was difficult to form an overall picture of the situation.

   More attention needs to be paid to operational deadlines that would be faced during an actual crisis. These include deadlines for the Stock Exchange, payments system and Collateral transfer.

   A combination of the above points meant that it was not possible to carryout a systemic impact assessment

It may be useful to prepare a list of key data sets that participants feel are important for evaluating a crisis. This list could also include a template of how this material should be presented to the relevant decision makers. This would allow decision makers to be more aware of what material is readily available, if available at all.

It might be useful to draw up a short (one-page) template in relation to the systemic impact assessment which would cover the key areas of concern. Each area would take responsibility for there own section of the systemic impact assessment. In this way the relevant sub-groups of the CSG could focus their analysis and briefing on the required assessment.

The above recommendations should reduce the issues of "too many voices" and allow the CSG to focus on the pertinent issues. The Red book should be revised in light of these concerns.

4. Based on the feedback provided by the players almost all indicated that they had read the **Red Book** prior to the crisis exercise. However, few indicated actually using the book during the course of the exercise. The most relevant parts indicated by the feedback forms were the contact lists, and the first three chapters (procedures for crisis management – summary, Systemic Impact Assessment – procedures and ELA procedures and Collateral Transfer Documentation)

Question: Were participants happy with the role of the Red Book in the exercise? In light of the feedback from the exercise does the DSG feel there are areas of the Red Book that need improving/reviewing?

5. The role of the **Deposit Guarantee Schemes** (DGS) needs to be looked at in more detail. It was felt that the decision to advise the DoF to guarantee all deposits was reached too quickly without looking at intermediate options and without sufficient thought given to the ultimate burden of responsibility.

There is ongoing work examining the policy issues surrounding DGS

Future Work on Crisis Management

Arsing from the exercise a number of areas have been highlighted by participants. These include:

- Further analysis into the interlinkages – interbank borrowing and lending positions – between institutions.
- Further analysis on the overseas operations of Irish banks and how they might be dealt with in a crisis. For example, would deposit assurance have to be extended to deposits at foreign branches of Irish banks – as in the Northern Rock case?
- Improve information and identify the key data required for dealing with a crisis
- Further work into the area of deposit guarantee schemes and deposit insurance.
- Examine the role of communication both internal and external further

Areas of Focus for Subsequent Crisis Simulations

Participants were asked to comment on areas of interest for future simulations. All three authorities highlighted the area of media relations and communication with the public. As already stated previously, further consideration is the need to coordinate a response and ensure that the correct message is conveyed to the public.

In addition to media relations some other areas suggested included:

- Circumstances when assurances, guarantees, commitments should be extended
- Examine if the necessary administrative arrangements/parameters including legal issues are in place. This may require advanced planning for each bank in advance
- More focus on specific roles played by individuals. Possible mini-exercises based on testing key aspects of certain roles.

In addition to the areas that need to be concentrated on in future exercises, participants offered feedback on the logistics of exercise. In general most consider that the CSE was conducted over too short a period and that future exercises should be conducted over a minimum of one day. This would allow participants to process the material more thoroughly. Based on the feedback it was felt that an actual crisis is unlikely to play out over the course of an afternoon.

A number of responses suggested a movement away from the paper-based format of this exercise, as it was too cumbersome. It has also been suggested that there should be greater involvement from the staff of relevant departments/authorities.

An exercise that is held over a longer period would greatly increase the workload required to prepare the necessary background material. However, the involvement of staff from the relevant department/authority would allow for a more realistic exercise. A dedicated person or team from each of the relevant departments/authorities could be involved throughout the planning process and implementation of the exercise would allow the material to be presented in a more realistic manner. The designated person(s) could also act as a point of contact in dealing with "players" queries during a CSE and allow for more interaction. This could help reduce/replace the paper-based format of the last game. However, it is worth considering, in reality, what level of involvement ordinary staff would have in a crisis.

The DSG is asked to review and discuss the feedback from the participants. From the discussion the follow-up steps can be agreed and crisis management procedures revised accordingly.

Annex: Extended Summary of CSE Feedback

Central Bank Feedback

General Comments

Overall, participants found the exercise to be worthwhile. In general the players found the plot to be realistic and found it topical. The main points of the Central Bank feed back are outlined below:

- A number of players indicated that the exercise was run over too short a period.
- The number of participants involved in the CSG presented logistical issues such as the sharing of information among the members. This led to a situation where individuals were talking among themselves rather than the CSG as a single group. This led to information asymmetries and hampered the ability of the group to form a coherent view.
- It was felt that the members of the Crisis Steering Group (CSG) were required to process too much information in a relatively short period of time. Given the flow of information, participants found it difficult to assimilate information and in turn it was difficult to form an overall picture of the situation.
- A combination of the above points meant that it was not possible to carryout a systemic impact assessment.
- The role of the Deposit Guarantee schemes needs to be looked at in more detail. It was felt that the decision to advise the DoF to guarantee all deposits was reached too quickly without looking at intermediate options and without sufficient thought given to the ultimate burden of responsibility.

Specific Comments

In terms of the comments based on how the exercise was played the following are points expressed by the Central Bank participants:

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- An area which may not have received sufficient attention are timing issues through the course of the day such as closing time of payments and deadlines relating to the Stock Exchange.
- There is a need to separate theoretical/conceptual issues from operational issues. During a crisis the issues should relate to operational issues in light of informed discussion on the theoretical issues. Theoretical issues, such as moral hazard and deposit protection should be dealt with prior to a crisis.
- It was felt that there should have been greater communication with the DoF. It appeared that at certain stages Finance were out of the picture. The apparent lack of contact and up-to-date information may have hampered the ability of the DoF to come to a clear decision in light of the available information.
- When initially briefing the DoF it was felt there was a need to have a representative from both the CB and FR. This is in order to be able to answer any bank specific question Finance may have as well as to represent the views of the FR and support the view of the CB where necessary.
- The role of the press office was highlighted as an area where careful work needs to be conducted. Specifically, the role of press releases from the relevant public authorities.

Role of the Red Book

In terms of the usefulness of the Red Book most participants glanced at it prior to the exercise. The most useful part related to the logistics of the CSG such as organisation and contacts list. Participants indicated that in general they did not use the Red Book during the exercise.

Future work on Crisis Management

Arsing from the exercise a number of areas have been highlighted by the participants. These include:

- Further analysis into the interlinkages – interbank borrowing and lending positions – between institutions.

- Improve information and identify the key data required for dealing with a crisis
- Further work into the area of deposit guarantee schemes and deposit insurance.
- Further analysis on the overseas operations of Irish banks and how they might be dealt with in a crisis. For example, would deposit assurance have to be extended to deposits at foreign branches of Irish banks?
- In relation to preventive measures, should there be greater analysis of the sustainability of banks' business models. Should the risk weightings of different asset classes be reviewed more frequently?
- Clarify precise requirements from various areas during the course of a crisis e.g., 15/30 minute updates of payments balances/queues and movements in collateral.

Areas of Focus for subsequent Crisis Simulations

Areas identified by CB participants for greater focus in future exercises include:

- Circumstances when assurances, guarantees, commitments should be extended
- Content of any press statement
- Ensure administrative arrangements/parameters including legal issues are in place; this will not be properly done without planning for each bank in advance
- More focus on specific roles played by individuals

Financial Regulator Feedback

General Comments

The participants of the Financial Regulator found the exercise to be constructive, relevant and timely. The case study dealt with the important issues such as solvency and liquidity. It raised certain issues that need to be addressed and highlighted the pressure situation that participants would find themselves in a real crisis. The main points of the Financial Regulator feed back are outlined below:

- The number of participants involved in the CSG presented logistical issues such as the sharing of information among the members.
- The length of the exercise was too short. The decision process would have benefited had the exercise been played over a longer period.
- The assessment of the crisis was unclear as there was no systemic impact assessment carried out
- Insufficient contact between the Regulator and the Department of Finance

Specific Comments

- There may have been too much communication and information sharing at the expense of identifying the information critical for crisis management
- There was no apparent conflict of interest between the CB and FR although the reasons for this may need to be examined further to ensure it was not just a function of this being an exercise only
- The roles of particular individuals, as outlined in the Red Book, need to be clearly explained to ensure everyone is aware of their responsibilities and the responsibilities of others.
- There may be some value in having a whiteboard or similar device in the CSG's meeting room to record key information and have it visible to all participants
- Would be useful to look at final decision again in the cold light of day – check validity

Role of the Red Book

In general people looked at the Red Book prior to the exercise, specifically the first three chapters, but did not consult the Red Book during the exercise.

Future work on Crisis Management

- The co-ordination of decision making seemed to work well at senior CB&FR levels but we should consider the potential impact if the Board and Authority members were to become involved
- As outlined in Annex 2 of the Red Book, the Task Force on Crisis Management has identified key information required to perform an assessment of the systemic impact of a crisis. Some of this information is already gathered but may not be readily available or sufficiently up-to-date when a crisis occurs. One priority should be to review these information requirements and decide if institutions (or a small number of them) should be required to provide additional information on a regular basis or to be able to produce such information at short notice.
- The need for a set of predefined templates for information and a central repository for recording new information as it arrives.
- Agreement is needed on how the Deposit Guarantee Scheme will operate in a crisis and what communication should be provided to the public. This is already being examined in the Sub-Group.
- Our role in relation to crisis management for Irish branches and subsidiaries of foreign banks and foreign branches and subsidiaries of Irish banks needs to be clarified.
- We need to explore what measures/options are available to handle a crisis apart from ELA or Government guarantees.
- Focus on the channel of communications. What are we saying publicly, especially in the early stages when we are unsure about the state of the ailing bank and any Government guarantee. Secondly who will be saying it - Minister/CEO/Governor etc.?

Areas of Focus for subsequent Crisis Simulations

- Consider a change in the format of the exercise. Move away from a paper based approach. Consider other channels of communication. In a real crisis the most immediate information would be communicated by telephone, face-to-face meetings and email
- In reply to: future simulation exercises there needs to be involvement of the staff of the CSG in seeking out and distributing information.
- Ensure that, whatever format future exercises may take, there are sufficient handouts and information for all participants.
- Examine the role of communication both internal and external further

Department of Finance Feedback

General Comments & Future Work in Crisis Management

The exercise was very useful in highlighting the range of issues that can arise in the context of a crisis. It demonstrated that a lot of work is required by all parties both individually and collectively (in the context of the work of the DSG) to increase preparedness to an appropriate level for responding to a financial instability event. The areas require further work include:

- Availability/'flow' of information between public authorities
- Communication/level of contact between authorities
- Assessment/analysis of options from an early stage
- Extent to which "CB" represents "FR" position in a crisis and vice versa, risk of second guessing by Department of 'political' objectives and potential for conflict of objectives that would arise between all parties
- Utility/benefit of pre-prepared material
- Role/effectiveness of MoU for DSG
- Slow responsiveness to need for public communication

Role of the Red Book

The Red book was not used much but was essential to know it is there.

Areas of Focus for subsequent Crisis Simulations

In planning the next exercise, a particular concern should be to test the central elements of the national response to a financial stability event (i.e. financial analysis of an individual institution in difficulty, liquidity / solvency assessment, ELA procedures, Eurosystem / ECB aspects, systemic analysis, interacting with media / political level, communications between national authorities, resolution issues etc.) rather than areas which are, while still important, more peripheral

The main priority should be to test rigorously the financial, legal and policy assessments that underpin our 'model' of crisis management and also drawing out the possible conflicts of objectives that may emerge in the course of the

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management of an event in order to pre-empt the risk that these may arise in practice.

THEME: C1

Effectiveness of the ECOFIN and Domestic Standing Group (DSG) (Central Bank, Financial Regulator and Department of Finance)

LINE OF INQUIRY: C1c

Role, responsibilities and objectives of the Domestic Standing Group (DSG)

(97)

(1)

Feerick, Niall

From: Beausang, William
Sent: 14 July 2008 11:42
To: Cardiff, Kevin
Subject: confidential report of DSG 8 July - may need to get CBFSAI to check
Attachments: DSG Meeting 8 July 2008.doc

Secret – for preparation for Government meeting

Report of Domestic Standing Group Meeting – 8 July 2008

Attendees
Tony Grimes, Central Bank
Brian Halpin, Central Bank
Con Horan, Financial Regulator
Kevin Cardiff, Department of Finance
William Beausang, Department of Finance

Recent share price declines
The CBFSAI was staying in close touch with the Irish banks; the sharp decline in Irish bank shares had not had any significant effect on their deposit base to date.

International developments
The CBFSAI believed that the decline in bank share prices internationally was helping to highlight the international market situation ahead of the domestic environment.

Liquidity
Irish Life and Permanent and Anglo Irish banks have both recently topped-up with liquidity in order to ensure that it remained strong against all eventualities.

Corporate Deposits
It was considered inevitable that weaker share prices would in time he reflected in some withdrawals of, in particular, corporate deposits.

Bank of Ireland trading statement
Bank of Ireland's interim management statement (8 July) was considered 'downbeat' but reflected concerns regarding the impact on profitability of the bank's exposure to the UK commercial property market

Long-term investors
There were some indications that recent falls in share prices reflected share sales by long-term investor indicating that if the current unfavourable market environment persisted there was an increased risk of a general loss of confidence in the Irish banks. International investors believed that the sharp slow-down in the Irish economy and property market would give rise to significant loan losses for the Irish banks, a collapse in profitability and the need to raise significant capital and that they would be disadvantaged in doing so on account of the delay in going to the market for additional capital, in contrast to the steps taken by some UK banks. This type of assessment does not correspond with that of the Irish banks. The FR reported a detailed line-by-line examination of its loan book by one of the major Irish banks which highlighted that even allowing for 'worst-case' loan losses, profitability would remain strong measured against objective market benchmarks.

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Establishment of a Domestic Standing Group (DSG) – roles, responsibilities and outstanding issues.

Scoping Paper arising from meeting 10 January 2007

Introduction

This paper follows a meeting between the Central Bank and Financial Services Authority of Ireland (CBFSAI), the Financial Regulator and the Department on Finance on 10 January 2007.This scoping document outlines what the function of a DSG is, the roles and responsibilities of the various parties and any questions that need to be addressed to progress the establishment of the DSG, consistent with the guidelines set out by the EFC/FSC.

What is a DSG?

The EFC/FSC describe the role of a DSG as follows:
The role of a DSG is to ensure full and timely information exchange and evaluate, prevent, and if necessary, manage potential systemic problems. A DSG should regularly evaluate and assess the systemic soundness of, and the risks to, the domestic financial markets. It can also be involved in the management and evaluation of domestic stress tests as well as regional, EU-wide or other types of simulation exercises, as well as function as the focal point of information exchange, planning and management on potential systemic financial problems, both nationally and with similar groups in other Member States.

The EFC/FSC have laid down a list of measures that we are required to implement with respect to our domestic financial stability framework. These measures with deadlines are:

- Establish Domestic Standing Groups (DSG) — July 2007
- Develop national contingency plan — January 2008
- Put together, where appropriate, institution specific interest groups for cross border financial institutions — No date given
- Carry out a crisis simulation exercise at national, regional or interest-group level — January 2008
- Stress test by central banks and supervisors — July 2008

The Department of Finance's current assessment of the primary function of a Domestic Standing Group is to facilitate information exchange and communication between the Department of Finance, the Central Bank and Financial Services Authority of Ireland and the Financial Regulator in relation to safeguarding financial stability. It is envisaged that the DSG will oversee financial stability planning between the three parties. The DSG's role must be underpinned by existing legal roles and responsibilities of the three organisations in their respective areas. It also requires the drawing up of an agreed Memorandum of Understanding (MoU) between the Department of Finance, the Financial Regulator and the CBFSAI.

For information a summary of the UK structures for crisis management is attached as an Appendix to this paper.

Legal Responsibilities:

At the onset it is important to ensure that the role and terms of reference of the DSG are consistent with statutory responsibilities of each of the parties under the current legal framework.

CBFSAI

The CBFSAI is responsible for contributing to the overall stability of the Irish financial system. This mandate comes from the Central Bank Act 1942, as amended, which states that "the Bank has......the objective of contributing to the stability of the financial system" and the mandate of the European System of Central Banks which requires the CBFSAI to contribute to financial stability in the Euro area.

The CBFSAI's responsibility to contribute to the overall stability of the financial system involves:

- ensuring the stability of the monetary system, monitored as part of the CBFSAI's Eurosystem monetary policy function. As necessary, the CBFSAI must take action in the market and deal with day-to-day fluctuations in liquidity
- ensuring the smooth operation of the payments system, advising the Minster for Finance and the Financial Regulator of any significant issues in the system and promoting improvements in the financial sector infrastructure increasing the efficiency and effectiveness of the sector
- providing an overview of the financial system, advising on the implications for financial stability of developments in the domestic and international markets and payments systems and assessing the impact on monetary conditions of events in the financial sector.
- identifying developments (macro- or micro-prudential, where appropriate) that could endanger system as a whole and advising on such issues, including publishing an Annual Financial Stability Report that reflects the views of the CBFSAI and the Financial Regulator.
- in exceptional circumstances, undertaking official financial operations in order to limit the risk of problems affecting particular institutions spreading to other parts of the financial system

Financial Regulator

The Financial Regulator is responsible for contributing to the maintenance of proper and orderly functioning institutions and exchanges and protecting consumers of financial services products. The Regulator supports the CBFSAI's objective of financial stability by carrying out these functions. The mandate from these functions comes from the Central Bank Act 1942, as amended.

The Financial Regulator's responsibilities are:

- the prudential supervision of banks, building societies, insurance companies, stockbrokers, exchanges, investment firms, retail intermediaries, credit unions and collective investment schemes
- providing advice, information and assistance in relation to the CBFSAI's functions

Department of Finance:
The role of the Department of Finance involves:

- promoting financial stability generally and a competitive and efficient market in financial services, with a strong focus on the consumer.
- ensuring that the financial services regulatory structure continues to meet the Government's consumer protection, competitiveness, and financial stability objectives.

Issues for Discussion:

Overall Role

1. Do any legal/accountability issues arise from the DSG's proposed functions as set out by the EFC/FSC? Are its roles and responsibilities aligned with the existing legal framework?

2. Should the DSG's role primarily relate to overseeing the coordination of emergency planning arrangements between the three bodies?

3. What role could the DSG play in relation to the functions highlighted by the EFC/FSC of "regularly evaluate and assess the systemic soundness of, and the risks to, the domestic financial markets" and the "management and evaluation of domestic stress tests"?

4. The Central Bank and the Financial Regulator have a Financial Stability Committee and a joint MoU already in place in order to facilitate co-operation on the issue of financial stability. Where does the DSG fit in with this Committee? Does it fulfil a similar function on a tripartite basis?

5. There are a number of groups and public sector structures responsible for contingency planning arrangements in different emergency scenarios, e.g. the Office of Emergency Planning in the Department of Defence. Is the proposed DSG the appropriate structure to deal with the financial stability dimensions of these broader emergency planning issues (e.g. maintenance of the payments system)? What issues arise with respect to the DSG's engagement with these other emergency planning structures?

Operational Issues

6. What is the appropriate level for the membership of the DSG and what organisation should chair it in view of its intended role?

7. How would the DSG interact with the three organisations participating in the DSG on both a routine and a crisis management basis?

8. What should the DSG's working methods, work programme and priorities for 2007 be?

9. How should the DSG go about its role of preparing an agreed Memorandum of Understanding between the parties?

10. What are the key informational requirements for the DSG to enable it to fulfil its role effectively?

11. Who are the key personnel in each organisation whose work needs to feed into the work of the DSG?

Liaison

12. What level of public disclosure of the work of the DSG is appropriate? In this context, what legal/confidentiality issues arise?

13. What issues might arise in relation to possible engagement with the private sector (e.g. payments system)?

14. Is consideration required of any of these issues at Board, Regulatory Authority or MAC level?

Proposed Next Steps

The next steps required for the establishment of the DSG by July 2007 and the meeting of the other targets set by the FSC are:

- the drafting of a tripartite MoU between the Department of Finance, CBFSAI and the Financial Regulator to establish the DSG (by July 2007)
- the clarification of the legal position of the three parties with respect to financial stability and financial crisis management (also by July 2007)
- prompt updating of operating manuals in the Department of Finance, CBFSAI and the Financial Regulator, detailing the policies and procedures should a systemic crisis occur. (contingency plan in place by January 2008)
- arrangement of a tripartite crisis simulation exercise (must take place by January 2008)

Appendix
UK Model of a DSG

Since the meeting of 10 January, the Bank of England has recently given a presentation in Dublin on Financial Crisis management. This presentation touched on some of the issues outlined above, particularly the level at which a DSG operates. The UK has a tripartite MoU in place between the Bank of England, FSA and the Treasury. There is a tripartite Standing Committee that deals with issues affecting financial stability. It is composed of the Chancellor (Chair), the Governor of the Bank and the Head of the FSA. This group of principals meet only when required, while monthly meetings take place at Head of Function level. In the case of a crisis, a Joint Crisis Committee is formed. This would be at Head of Function level for each party. Relevant information, etc is fed from the relevant sections of the three organisations through the Joint Crisis Committee to the Standing Committee. It is the Chancellor, the Governor and the Head of the FSA who have to make the relevant decision in a crisis. Business Continuity Planning (Operational Crisis Management) is also deal with by the Standing Committee. However, the responsibilities of the organisations are different in the case of an operational crisis, which would have, by its nature, more parties involved, e.g. the police, Home Office, etc.

6a.

Draft Initial Work Programme of the Domestic Standing Group on Financial Stability

The proposed work programme for the DSG will include ~~involve~~:

- overseeing the prompt updating of operating manuals in the Dept of Finance, CBFSAI and the Financial Regulator, detailing the policies and procedures to apply should a systemic crisis occur. The EU FSC/EFC requirements on domestic financial stability arrangements require these contingency arrangements to be in place by January 2008;
- conducting a tripartite crisis simulation exercise and reviewing the outcome of this exercise. To comply with the EFC requirements this also must take place by January 2008;
- making arrangements for developing general principles to guide the resolution of a financial crisis, taking account of EU work in this area;
- examining the role of the DSG in responding to operational disruption of the financial system and business continuity arrangements for the financial system, particularly in the context of the EU's initiative in the area of critical infrastructure protection; and
- examining the implications for information exchange between the parties of FOI legislation and the professional secrecy provisions of the 'Supervisory Directives' as defined in the Central Bank Act 1942 as amneded;
- examining the impact of Company Law provisions relating to insolvency on potential crisis management operations.

July 2008

Mr Paul Gallagher SC
Attorney General
Government Buildings
Upper Merrion Street
Dublin 2

Re: SECRET - Financial Stability Contingency Planning

Dear Paul

I write seeking your agreement for the priority drafting of primary legislation proposals relating to the maintenance of financial stability.

Arising from the current financial markets dislocation and EU requirements for national contingency planning and crisis management, my Department has been reviewing the options available to Irish authorities in a situation where there is considered to be a systemic threat to financial stability. The review raised a number of legal issues on which we were grateful to receive your and your Office's advice.

While we remain confident about the financial stability and profitability of our banks we have concluded that a priority for contingency planning is to have ready a robust legislative proposal that the Government and Oireachtas could consider at short notice for enactment to facilitate the immediate transfer to public ownership of a specific distressed financial institution. My Department has therefore been in contact with Advisory Counsel (Mr Jonathan Buttimore) in your Office in relation to provisions that would be appropriate for inclusion in a bill designed to provide that the Minister for Finance could, in certain circumstances, transfer the securities of a financial institution in difficulty to the Minister. Given the pressing nature of the circumstances in which it would be used, the draft legislation will need to be concise and practically orientated. I understand that once legal approval is received draft heads of a bill will be finalised and ready for legislative drafting.

Government procedures normally require prior Government authority for the referral for detailed drafting of primary legislation proposals to the Office of the Parliamentary Counsel. However, given the exceptional sensitivity of the matters concerned and the urgent need to ensure an appropriate level of preparedness for a financial stability event, I would ask for your agreement that the normal conventions

are set aside on this occasion and that my Department is permitted to lodge heads of a bill with the OPC. I envisage my Department being in a position to forward the finalised heads of a bill to the OPC in mid to late July and that approximately seven heads would be involved.

I do hope you can agree to this course of action.

Yours sincerely

Brian Lenihan TD
Minister for Finance

12C

Lonergan, Ciara

From: Beausang, William
Sent: 16 November 2007 11:01
To: Manley, Michael
Cc: Nolan, Kevin; Lonergan, Ciara
Subject: Agenda for today's DSG meeting

Could you compile something to the effect

- FSR - update on response / any follow up issues
- update on financial market environment and situation of Irish banks
- update on planning for simulation exercise
- update on contingency planning

Confidential

1. Beausang (To see)
2. Tánaiste

CBFSAI Assessment of Financial Market Developments 16 November 2007

The attached report sets out the most recent assessment of the Central Bank and Financial Services Authority of the current situation presented at the Domestic Standing Group meeting on 16th November. The main points arising were as follows:

- Funding availability for Irish banks is tight. This situation is likely to be exacerbated by:
  - End-of –year pressures as banks seek to close off positions.
  - A number of Irish financial institutions have significant 'roll-over' funding requirements arising from the beginning of next year. **If the present market conditions persist, as expected, into 2008 there is an increased risk of liquidity issues arising for Irish banks.** The Irish banks are therefore engaged in contingency planning (incl. restructuring assets to provide collateral, restricting lending growth) to meet future funding needs.

- While Irish banks have, to date, absorbed the increased cost of funding there are already indications they are tightening credit standards, potentially impacting on economic performance.

- There is anecdotal evidence that the change in the financing environment and restriction of lending is impacting on the property development sector.

- Irish banks share prices have continued to fall and have lost between 30% and 50% of their value since the start of 2007 because of negative investor sentiment regarding Irish banks and their exposure to the Irish property market.

- Speculation against Irish financial institutions is an important element of the overall financial landscape, underlining the importance of **highlighting the inherent strengths of the Irish financial system and economy.**

The Department will continue to liaise with the CBFSAI, which in turn maintains high level links to the Irish banks and are monitoring the position very closely.

Michael Manley
28 November 2007

Confidential

CBFSAI Assessment of Financial Market Developments
16 November 2007

The level of activity in the interbank lending market remains low

In the euro area, the level of lending activity in the interbank market remains low by normal standards. There is good availability of funds at short maturity (1 month), but very limited at longer maturities, e.g. 3 month. While Irish banks are continuing to meet their funding needs in a difficult market environment in November, there are recent indications that the funding environment has deteriorated in particular in the unsecured interbank market. A covered bond issue by one of the major banks week commencing 19 November will be important in testing the appetite for Irish-economy based risk in the international marketplace.

Interbank rates remains high

Interest rates remain above the target 4% rate, particularly in the 3 month market, standing at 4.584% [Friday, 16 November rate], down from a peak of 4.795%. at 2 Oct. The 3 month rate is an important determinant of retail lending rates for the Irish banks – to date the banks have absorbed the increased cost of funding, but as this higher cost continues it puts upward pressure on lending rates charged to individuals and business. There are already indications that Irish financial institutions are tightening credit standards on account of the higher funding costs. This 'credit rationing' has the potential to impact on economic performance owing to the reduced availability of finance for investment and consumption.

"End-of year premium" will increase costs of accessing liquidity in the interbank market but ECB can inject liquidity into the market if required

At end-year there is usually a premium for cash as credit institutions close off their positions. In the current disrupted financial market conditions this "end-of-year premium" adds to the premium already present. Available liquidity in the market place is being reduced as major international banks hoard liquidity to meet their own requirements including to meet losses on sub-prime investments and to take on balance sheets exposures in conduits and SIV that were previously off balance sheet. In view of the scale of expected sub-prime losses against those currently disclosed, uncertainty remains in the market in relation to where losses are located – hedge funds are a source of concern in this respect.

In such circumstances second-tier banks (such the main banks in Ireland) are subject to greater pressure to secure funding. This is creating increased pressures on domestic financing institutions to restrict their lending activities or offering finance on stricter terms in order to support their liquidity position.

The ECB is continuing to prepare to intervene as required to provide liquidity to the market. However, this funding is provided at above market rates and is less attractive to banks which have mange their liquidity while minimising the cost of funds. Where

banks have good quality assets as lending collateral, they are using it to access market funding at more competitive rates. This suggests that any increased access to ECB liquidity is evidence of increased financial stress.

Irish banks are managing their funding requirements with increasing difficulty

Banks are reporting to the CBFSAI that they are managing their liquidity, but that this is increasingly difficult given the tightness of liquidity in the money markets and the price of funds. As available funding is increasingly shorter term, this is compressing the maturity profile of the banks' funding. In circumstance of continuing credit market difficulties, this increases funding pressures in Irish banks. There are some indications that Irish banks are being subject to more refusals in the unsecured interbank market on account of negative international sentiment regarding the Irish banking sector and the Irish property market generally and events such as the high-profile solicitor cases and the recent difficulties in ISTC. As a small economy with a peripheral presence in international financial markets, large institutional investors may be inclined to by-pass the Irish market in a situation where market sentiment regarding the financial sector and the property market has been negative.

2008 will present particular challenges. Banks are currently executing contingency funding arrangements

A number of Irish financial institutions have significant funding requirements arising from the beginning of next year. In advance of this they are taking a number of steps to prepare for an eventuality that this funding rollover takes place against the backdrop of a resurgence of difficulties in international credit markets. These include steps to build up collateral requirements through, for example, securitisation transactions that will facilitate borrowing from the ECB if they are not able to access liquidity from the usual channels in those circumstances. Other measures that are available to Irish banks to prepare for this eventuality is to restrict lending growth. According to the FR there is anecdotal evidence that the change in the financing environment is impacting on the property development sector as projects are postponed (which for major projects alleviates somewhat funding pressures on the banks). The quality of assets secured on speculative development land is a particular focus of attention for financial institutions at this time.

Internationally, on a day-to-day basis longer term (i.e. 6 month and 12 month) funding is being rolled over into shorter-term (i.e. 3 month) debt. This process gives rise to a heightened risk of a major demand-supply balance on an ongoing basis. **Therefore, notwithstanding contingency measures adopted by banks to enhance their access to liquidity if the present market conditions persist, as expected, into 2008 there is an increased risk of liquidity issues arising for Irish banks.**

International investor views and the share price of Irish banks have continued to fall

Irish bank share prices have continued to fall and have lost between 30% and 50% of their value since the start of 2007. Notwithstanding the posting of good results by Bank of Ireland on Wed. 14 November, its share price fell a further 6% that day, at one point falling by 8%, perilously close to the 9% figure at which trading in a share

is temporarily suspended. The decrease in value of Irish banks shares has been greater than in other countries. There is a general discount in the value of Irish banks as there is a perception internationally that they are exposed to the property market – reinforced in a 7 November report from Merrill Lynch setting out a negative perspective on the Irish banking sector because of property exposures. Possible hedging Intense speculation against Irish financial institution is an important element of the overall financial landscape including the activities of hedge funds and the possible hedging of exposures of commercial property bonds issued by Irish property developers through short-selling of Irish bank stocks. In the present uncertain climate, any negative event/comment is subject to amplification in international markets impacting on the share price of banks and the availability of funding. **Taking-up appropriate opportunities to highlight the inherent strengths of the Irish financial system and economy are therefore considered to be very important.**

Timeframe for normalisation of market situation

The view is increasingly being expressed by commentators, analysts and individual financial institutions that the current market disruption will take an extended period (i.e. up to 2 years) to resolve. At the same time there is continued uncertainty regarding the scale of losses on investments associated with US subprime mortgages with some estimates now a multiple of initial forecasts of €100bn. Developments in the US property market are expected to influence strongly the future direction of these estimates

The major risks for financial markets are a US recession impacting in particular in the US property market which leads to a degrading of assets backed by non-subprime mortgages or large losses by a major hedge fund leading to a forced sales sub-prime backed assets.

Contingency Planning Arrangements

The Central Bank and Financial Regulator continue to liaise with the Irish banks closely at CEO level and are monitoring the position very closely. The banks in turn are working intensively to implement contingency arrangements to meet their liquidity requirements.

To:

1. Mr. K Nolan
2. Mr. P Ryan
3. Mr. W Beausang

cc: Kevin Cardiff

Re: Initiating Domestic Standing Group for crisis management / financial stability – meeting 6 March 2007

Please see attached note which outlines the main points arising at a meeting between Department of Finance, Central Bank and Financial Services Authority of Ireland and the Financial Regulator, where the establishment of a Domestic Standing Group was discussed.

Ciara Lonergan
19th March 2007

Note of Meeting between Department of Finance, Central Bank and Financial Services Authority of Ireland (CBFSAI) and Financial Regulator re initiating Domestic Standing Group for crisis management/financial stability
6 March 2007

Attendance:	CBFSAI:	Tom O'Connell
		Tony Grimes
		Ann Marie McKiernan
	Financial Regulator:	Con Horan
	Department of Finance:	William Beausang
		Phil Ryan
		Ciara Lonergan

This note records the main points arising

1. **Role of DSG**
   It was agreed that the role of the DSG is to co-ordinate information sharing between the CBFSAI, the Financial Regulator and the Department of Finance within the framework of the current legal powers of each authority. The existing roles and responsibilities of all three authorities will remain unchanged. The DSG will gather together information and will be briefed on work on financial stability issues being undertaken in the three authorities. The DSG will operate at a macro level overseeing the financial stability environment generally and appropriate planning arrangements. The DSG will also plan and manage crisis simulation exercises. It may be appropriate for the DSG to set up working groups examining for example in more detail relevant BCP/critical infrastructure issues (see point 3 below)

2. **Interaction of DSG with the existing financial stability framework**
   The DSG should dovetail with the existing stability framework, without overlapping with current arrangements. The Financial Stability Committee of the CBFSAI and the Financial Regulator examines financial stability at a macro level. There may be "added value" by the inclusion of the Department of Finance perspective, for example the economic and tax side may have useful information to input into the assessment of the DSG. The meetings of the DSG could align with FSC meetings to facilitate the information sharing role of the DSG.

3. **Business Continuity Planning (BCP)/Critical infrastructure Protection (CIP)**
   The CBFSAI's current work on BCP has two strands. The first strand is internal BCP for the CBFSAI's operations. This is currently being developed with the aim of having all systems replicated in the Sandyford Currency Centre. The second strand involves dialogue with industry in relation to BCP in the financial sector. The CBFSAI is currently talking to the IBF, who have been working on BCP issues independently. The CBFSAI does not become engaged at a detailed level with this type of BCP but needs to be assured that appropriate BCP is in place in the industry. Discussions carried out with the IBF have looked at the main issues: liquidity, payments system and broader "cash" issues.

The EU proposals for CI protection relate to European Critical Infrastructure (ECI) which is "those infrastructures, the destruction or disruption of which would ***affect two or more member states*** or a single Member State if the critical infrastructure is located in another Member State." In relation to the financial infrastructure in Ireland the key ECI is the Target payment system
With respect to the DSG, the DSG's role in BCP/CIP needs to be explored in detail. The extent to which a problem with the financial infrastructure is an issue for the DSG will need to be scoped out – the key issue is whether an infrastructural problem will lead to systemic problems. It will be important in examining this issue to also look at the probabilities of different scenarios and their impact on the financial system overall.

4. **Crisis Vs Non-Crisis role of DSG**
It is important to distinguish between the appropriate role of the DSG during a time of crisis and during non-crisis times. Generally its role will be as described in point 1 above. In a crisis situation the DSG's role will be to advise the principals in each authority. As in a non-crisis situation, the roles and responsibilities of each authority are without prejudice to the exercise of statutory responsibilities by the constituent authorities. The majority of work required for any support operation would take place within each authority with the DSG facilitating information sharing and co-operation between the organisations.
The benefit of the DSG in a crisis situation is that its members will have developed their familiarity with the procedures and issues arising in such a situation, through briefing and simulation exercises. These simulation exercises will help clarify the role of the DSG in a crisis situation. Some further examination of the DSG's specific role in a crisis may be required.

5. **Membership of DSG**
The general business of DSG will be undertaken at the level currently attending these preliminary meetings, with representatives from the CBFSAI, the Financial Regulator and the Department of Finance.
In addition to the three organisations who make up the DSG, in times of crisis the DSG may need the assistance of other public authorities (e.g. the Office of the Attorney General, the Department of Enterprise, Trade and Employment and the NTMA). The DSG may have to ensure that there is a contact point in each organisation available as required. This may be included as part of the three authorities' operational manuals rather than outlined in the MoU governing the DSG.

6. **Public disclosure/confidentiality**
The European Central Bank has tended to say very little about financial stability planning/financial crisis management arrangements. The MoU on crisis management and the tripartite cross border MoU between Ministries of Finance, Central Banks and Authorities are not published. The CBFSAI has tended to follow the ECB's example and has not published material on financial crisis management.
Practice on whether DSG and financial crisis arrangements are publicised varies from country to country in the EU. Those that have published information (e.g. UK, Sweden) have tended not to be in the Euro system

although the Benelux countries, particularly Belgium, have a significant amount of information in the public domain.

7. **Future EU Developments**
The work of the EFC Ad hoc Working Group on financial crisis management may lead to further requirements for Member States in this area. The Group's interim report is to be presented at the EFC meeting in March.
Financial stability/financial crisis management requirements may be raised at the EFC Financial Stability Table in April and September.

8. **Next Steps: Memorandum of Understanding**
A key priority for the DSG is the preparation of a draft MoU outlining the composition of and role of the DSG and the member's roles and responsibilities, highlighting the fact that the establishment of the DSG does not affect the existing legal framework. The Department of Finance will draft a preliminary MoU to be circulated to all parties and arrange bilateral meetings as required. The agreed draft would then be discussed at a meeting after Easter and the preliminary agreed draft could then be submitted for approval in the Department of Finance, the CBFSAI and the Financial Regulator.

____
Ciara Lonergan

Informal Meeting of the FSC 7 July 2006

Item 3: Crisis management exercise: lessons learned and possible follow-up.

Further assessment on the basis of the preliminary report of the HLWG.

What will happen today?

It is likely that the Committee will discuss the first report of the High Level Working Group together with the two written opinions from external observers David Vegara and Manuel Sebastião of 18 May 2006, both of which set out preliminary observations on the outcome of the Financial Crisis Simulation Exercise which took place in Frankfurt am Maim between the 5th and 7th of April 2006. These reports were presented to and discussed by the EFC at its meeting on 29/30 May 2006.

The HLWG report is preliminary in nature and accepts that potentially important issues concerning the way in which the crisis management process developed and influenced end results require further clarification during the coming months. It restates the objectives of the exercise; the key design elements; key design assumptions and limitations; the plot; preliminary findings and next steps. The report from the external observers Vegara and Sebastião covers similar ground.

Background:

The informal Ecofin council, on the basis of a FSC report endorsed by the EFC, established priorities for the development of EU- wide arrangements for financial crisis management in September 2004. These included

(i) a review of national level financial crisis management arrangements in the EU,

(ii) a Memorandum of Understanding on cooperation between EU Banking Supervisors, Central Banks and Finance Ministries in financial crisis situation and

(iii) a decision to periodically arrange financial crisis management simulation exercises both at national and EU –levels.

The first priority was fulfilled through the surveys carried out by the Financial Services Committee; the second, the Memorandum of Understanding between national banking supervisors, central banks and finance ministries came into effect in July 2005 and the third priority - an EU-wide financial crisis management simulation exercise is the subject of today's reports.

The Irish participants in the exercise were :

Mr. Frank Browne – Central Bank

Mr. Con Horan – Office of Financial Regulator

Mr. William Beausang – Department of Finance

The exercise itself

- The overall objective was to test cooperation and coordination arrangements among the authorities responsible for financial stability in the EU in the case of a cross-border systemic crisis affecting several Member States.

- The primary focus of the exercise was on the framework for cross-border co-ordination between authorities.

- The exercise was designed to be *neutral* with regard to institutional arrangements in each Member State and *manageable* in terms of simplifying the real market complexities.

- The exercise was based on hypothetical countries and hence hypothetical (but representative) banks and banking systems.

- The exercise simulated the occurrence of a severe shock, initially related to high exposure to an industrial company, affecting banking groups with cross-border operations in several Member States.

What are the main observations made by the HLWG?

- The exercise is likely to have been a valuable training and knowledge-broadening experience.

- There appeared to be a general willingness to cooperate fully. The fact that the situation was an exercise may have exaggerated the pre-disposition to cooperate.

- Open communication and pro-activity appeared to be instrumental in identifying and reaching comprehensive solutions.

- Communication within countries may have been generally better than between those countries in need of information relevant to them.

- The exchange of information among central banks of was relatively intense in comparison to other multilateral set-ups.

- There appeared to be no common approach to assessing the systemic impact of the crisis.

- Insufficient consideration was given to the potential impacts and numbers of public statements and the extent to which they needed to be consistent and co-ordinated.

- The exercise set up the potential for a discussion on cross-border burden sharing where public support was deemed necessary. These issues appear to have been tackled fairly differently in the three different streams with significantly contrasting results

- While issues of competition law did arise in the discussions, no contacts to the Commission were initiated.

- While the exercise was generally seen as useful, improved cooperation between Member States and their relevant authorities is however called for .

What are the main observations made by the external observers?

- Usefulness was more practical than political.

- The crisis scenario chosen was realistic in that it conveyed the idea that a problem in a non-financial company could be a source of a systemic crisis.

- Subject to certain limitations such as the absence of communication with the private sector, the absence of securities markets supervisors and the fact that teams were organised on a non-national basis, the exercise was conducted in a reasonably realistic environment.

- Too much focus on burden sharing could be counter-productive

- It is very difficult to attempt to draw far-reaching policy conclusions from an exercise which is partial and imperfect by nature.

- The question remains if additional measures should be envisaged in order to avoid potential bankruptcy exposures of banks to major firms that could in turn evolve into financial systemic-risk situations.

- The exercise fulfilled its objective in a highly satisfactory manner.

What suggestions are made for the future?

HLWG next steps :

- Final report will suggest priority issues or, where relevant, alternative ways of achieving further progress.
- Final report will be discussed at the informal Ecofin in September but before that by the EFC.
- It is important to agree on continued coordination of crisis management work, including coordination of crisis simulation exercises, at the EU level.

External observers :

- Widen the scope of the participating actors
- Include tighter restrictions
- Frequency should be every two to three years
- To be closer to real world and to reduce costs an alternative model which does not require the bringing together of participants should be explored

Is any intervention needed?
Not at this point in time. (see however comments from Wm. Beausang Assistant Secretary to Noel O'Gorman dated 11 May 2006.)

in developing the current framework, particularly the need to (1) support decision-making and the use of policy measures in handling a crisis situation; and (2) enhance clarity in the division of responsibilities between authorities, including burden-sharing in a systemic cross-border crisis where markets-led solutions are not possible.

6. Based on the findings of the simulation exercise, the EFC reaffirms the importance of developing the national structures and procedures for crisis management as outlined in the EFC Report of September 2004[10] and the FSC's assessment of March 2006[11]. Accordingly, each Member State is expected to establish **domestic standing groups[12] by July 2007;** develop national **contingency plans[13]** by January 2008; and put together, where appropriate, institution specific **interest groups[14]** for cross-border financial institutions; carry out a **crisis simulation exercise** in each Member State at national, regional or interest-group level **by January 2008;** and perform **stress tests** by central banks and supervisors July by 2008. The FSC is invited to monitor progress in these areas and ensure that experiences are being exchanged between Member States and **best practices** are being adopted.

7. The simulation exercise indicated that although the principles set out in the **Memorandum of Understanding (MoU)** agreed in spring 2005 provide a useful basis for cross-border cooperation in a financial crisis situation, the provisions were not yet fully absorbed and efficiently used in the exercise. Therefore, national authorities should continue developing and regularly testing procedures for cooperation with authorities from other Member States In this context, the focus should be on joint evaluations and assessments of information; consulting on information to be given to the public; and providing advance notice of decisions to be

[10] Doc. ECFIN/CEFCPE(2004)REP/50244 FINAL of 11 September 2004.
[11] FSC non-paper to the EFC Financial Stability Table of 20 March 2006.
[12]Groups consist of competent supervisory authorities, the national central bank and the representatives from relevant Ministry(s) within a Member State. This co-operation can be formalized by an MoU agreement. Such groups have been established in several Members States for stability and crisis management purposes e.g. to prepare contingency plans to conducts crisis simulation exercises and exchange information to facilitate possible policy responses.
[13] Arrangements put in place beforehand, typically by an individual institution or authority; or between several parties to ensure continuity of operations and to facilitate possible policy actions.
[14] A joint interest group for stability and crisis management purposes, consisting of relevant authorities from at least two Members States. Such groups cooperate and exchange information regularly on a financial institution with cross-border activities; and may e.g. agree ex-ante on procedures and actions in a crisis situation.

APPENDIX 2

Draft Press Release

Minister Shatter publishes Scheme of Personal Insolvency Bill

The Minister for Justice and Equality, Mr. Alan Shatter, T.D. today announced that the Government has approved the drafting of the Personal Insolvency Bill along the lines of the draft General Scheme attached.

The drafting of the Bill will be arranged on a priority basis so that it can be published by end of March - in line with the commitment in the EU/IMF Programme of Financial Support for Ireland. The drafting of the Bill will be subject to ongoing consultation with relevant Departments and the Attorney General. The Minister has forwarded the Scheme to the Joint Committee for Justice, Defence and Equality for their consideration, in line with the commitment in the Government Legislation Programme for the Autumn Session;

The Minister said that his proposals for the reform of personal insolvency law will involve the following:

- the introduction of a non-judicial Debt Relief Certificate system to allow for the settlement of unsecured debt up to €20,000, subject to certain conditions, after a one-year moratorium period;
- the introduction of a non-judicial Debt Settlement Arrangement for the agreed settlement of unsecured debt of €20,001 and over;
- the reform of the Bankruptcy Act 1988, to include the introduction of automatic discharge, subject to certain conditions, after 3 years in place of the current 12 years;
- the establishment of an Insolvency Service to operate the proposed new non-judicial insolvency arrangements.

The Minister said that the development of modern insolvency law will also fulfil his Department's obligations in respect of implementation of the Keane Report on Mortgage Arrears of October 2011. That Report stated that "the early introduction of new judicial and non-judicial bankruptcy options is vital; but this is highly complex and will need to be properly resourced. Without effective bankruptcy legislation the mortgage arrears problem will not be resolved".

Minister Shatter further said "I am of the view that new personal insolvency laws, including the bankruptcy law reform, should provide a significant incentive for financial institutions to now develop and implement realistic agreements to manage or settle debt with their customers".

The Scheme of the Bill will be available shortly on the Department of Justice and Equality website *www.justice.ie*

December 2011

THEME: C1

Effectiveness of the ECOFIN and Domestic Standing Group (DSG) (Central Bank, Financial Regulator and Department of Finance)

LINE OF INQUIRY: C1d

Adequacy of the DSG process, including a consideration of the bank resolution legislation

European Union
Financial Services Committee

Brussels, 8 February 2006

NON PAPER for discussion

from :	Chairman
to :	Members of the FSC
Subject :	Update of the FSC Survey on national arrangements for Financial Stability and Crisis Management – Assessment and policy issues

1. Background

1. The EFC Report to the Scheveningen 2004 Informal ECOFIN on "Next Steps in developing the EU framework for financial stability and crisis management"[1] set out priorities for 2005-2006 at both EU and national levels in the follow up of the Brouwer reports. The Report drew on extensive work carried out by the FSC, in particular the May 2004 outcome of the Survey on national financial crisis management procedures and the subsequent operational conclusions in the July 2004 Report by the FSC Vice-Chairman[2].

2. At the national level, the recommendations in the EFC Report were the following:

[1] ECFIN/CEFCPE (2004) REP/50244 FINAL
[2] "Developing a framework for managing financial stability problems in the EU"- 30.06.2004 (not published)

DOF01B06

DOF06134-001

- *"The EFC urged all Member States to review their national arrangements and to enhance them where needed, e.g. by creating domestic standing groups* (composed of all relevant authorities, including Ministries of Finance), *and, in this context, to develop contingency plans".*
- *"supervisors and central banks are invited to further develop stress tests and share the aggregate results with finance ministries on a periodic basis".*
- *"The effectiveness of national and EU level crisis management arrangements should be tested by crisis simulation exercises…"*

The FSC was invited to monitor progress in this area and report back to the EFC.

3. In October 2005, the FSC members were invited to update their answers to the first FSC survey on national arrangements for financial stability and crisis management, indicating those that had been changed since November 2003, taking into account the conclusions of the 2003-survey and the new MoU on co-operation between the Central Banks, Banking Supervisors and Finance Ministries of the European Union in Financial Crisis Situations.

4. The synoptic analysis of the responses to the update of the survey is presented to the FSC in a separate non-paper. On the basis of that analysis, the present non-paper has been elaborated for the attention of FSC members. Following the examination in the FSC, a revised non-paper setting out the position of the Committee will be transmitted to the EFC

2. Assessment

5. The EFC Report put forward a comprehensive and ambitious programme of action with the aim of setting up adequate mechanisms for financial stability and crisis management to deal with a more integrated and complex financial system. In short, what was decided was to build an EU framework with the involvement of all relevant authorities through an MoU, contingency planning and crisis simulation exercises, and to complement this with national systems along the same lines, even if the detailed set-up of national arrangements is left to the discretion of Member States.

6. Progress has proceeded rapidly at the EU level, with the signature of the MoU in July 2005 and the preparations for the April Crisis Simulation Exercise well advanced. At the national level, however, the results of the Updated Survey show that **progress is uneven and from an overall perspective, unsatisfactory**.

7. First of all, the degree of compliance with the request of the FSC to update the 2003-2004 survey has been disappointing, considering that two months were given for completing the work. On the expiry of the set deadline (16 Dec.2005), only 9 Member States had responded on time. To date, only another 10 Member States have provided responses, while the answers from 6 Member States are still missing. Insofar as this stock-taking survey is concerned, this situation has made it more difficult to come up with a complete and accurate picture of the state of, and the progress in, national systems for crisis management. Furthermore, it may illustrate an insufficient level of commitment and a delay in the underlying implementation work following the aforementioned EFC recommendations in a number of Member States.

8. The analysis of the responses to the Updated Survey received to date shows that progress has been uneven. In several Member States national systems have been revised and work has been carried out to comply with the recommendations in the EFC Report, starting in many cases with the creation of domestic standing groups with the participation of Ministries of Finance. Yet, there are also some Member States where the absence of any significant change or initiative leads to the reasonable presumption that the revision has not taken place.

9. Even after taking progress into account, national systems in a large majority of Member States are still quite far away from the standards set in the EFC Report. With the information available at this stage, **only four Member States (DK, FIN, SE and UK) have systems that can be reasonably considered to comply fully with all the standards**[3].

10. Given the political priority conferred by ECOFIN to crisis management, the FSC should recognise that **progress is unsatisfactory and much remains to be done**. The discussion should hence focus on **how to give momentum to bringing national systems in line with the recommendations**.

3. Policy issues

Agreeing on realistic deadlines with clearly defined objectives

11. Putting in place an effective system to deal with financial stability and crisis management is a challenging task for Finance Ministries. It demands an intensive use of time and human resources; it is technically complex and it entails a substantial effort of co-ordination with

[3] Consider the first three columns in the overview table provided in Annex 1 to the Non-paper providing a synoptic analysis of the responses to the update of the 2004 Survey.

central banks and supervisors. Furthermore, **as the 2004 Survey showed, in a majority of Member States the involvement of Finance Ministries in these issues was limited or non-existent**, which raises the cost of building a system along the lines recommended in September 2004. The conclusion is that **fulfilling the goal set in the EFC Report will take time**.

12. The build-up of an effective national system has a **logical sequence**, starting with the creation of a domestic standing group, which is undoubtedly the cornerstone of the whole framework[4]. The group then develops national contingency plans and regularly examines the aggregate results of stress tests[5]. The functioning of the system is then tested periodically by crisis simulation exercises arranged both at national and EU levels. This sequence could be used to **set deadlines** for complying with the main standards in the EFC Report in the following way:

   - **[By July 2007]**. Creation of a **domestic standing group** and development of **national contingency plans**. It should be clear that the groups should comprise the Ministry of Finance and that the plans should cover all participating authorities and not just central banks and/or supervisors.

   - **[By January 2008]**. **Crisis simulation exercise** and **sharing of aggregate results of stress tests with Finance Ministries**. The exercise should involve at least those authorities belonging to the standing group.

Do Members agree that pragmatic deadlines will help to give momentum to the process? Do Members consider the proposed course of action and deadlines appropriate?

Developing a positive peer pressure mechanism

13. The only tool to promote compliance with the EFC Report recommendations is **peer pressure**. Regular assessments of Member States systems, with a possible scoreboard for consideration by EFC-FST, are supposed to provide sufficient incentives for Member States to fulfil these recommendations. Yet, the risk of relying exclusively on this approach is that the focus would

[4] Paragraph viii of the Executive Summary of the Vice-Chairman Report reads "The report recommends that each Member State should, as a matter of priority, create standing domestic groups of all sector supervisors, the national central bank and the Ministry of Finance (or other relevant Ministry) for information exchange and for preventing, evaluating and managing potential systemic problems".

[5] As proposed in the Vice-Chairman Report, the stress tests could in the future be based on shared assumptions among authorities from Members States such as specific features to be tested and a common set of macro- and microeconomic assumptions.

tend to be more on the score in a table that on the real improvements in the components of the crisis management system.

14. Giving a clear picture of progress in each Member State will of course be a necessary feature of the process. But there could be merit in **complementing this traditional peer pressure** mechanism with a more positive side, **by making the FSC discuss on the specific problems, practices and experiences** in developing each of the elements of the crisis management system. For instance, a specific point on domestic standing groups could be included in one of the **2006** FSC meetings; one or two Member States (preferably in different stages of compliance with the standards) could be invited to present their experience. This kind of discussion and best practice-sharing could help FSC members to speed progress as well as to make their systems more effective. **At a later stage**, discussion could also cover experience drawn from the practical set up of national contingency plans and step up to good practice in preparation for the national crisis simulation exercises. The **EU-wide crisis simulation exercise** (April 2006) could also be a complementary source of inspiration for initial discussions on this latter topic.

Do Members see merit in developing this positive peer pressure mechanism? Do members consider that examining, in the FSC, experiences in creating effective domestic standing groups and in developing contingency plans, stress tests and simulation exercises could be useful?

A lighter monitoring process

15. The FSC survey on national arrangements for financial stability and crisis management has been an extremely useful tool to get a comprehensive view of the state of national systems and to base the recommendations to improve them. Yet, keeping the survey to monitor progress from now on could be unnecessarily burdensome, as evidenced by the outcome of the Update. If the **deadlines proposed** above are retained by the FSC, the Secretariat would suggest that, unless there is any objection to this new approach, **Member States should just be asked to give a short account of the compliance with the corresponding element some time before the deadline expires**. This simplified mechanism would avoid having to rely on supervisors and central banks to report the progress, which may otherwise significantly complicate the task for FSC members.

Do Members agree that the monitoring process should be streamlined?

REVIEW OF NATIONAL ORGANISATIONAL CAPABILITY FOR THE MANAGEMENT AND RESOLUTION OF SYSTEMIC FINANCIAL CRISES

"It is important to have a framework for crisis management in place before you need to use it. This …can help make any future crisis less painful. Having a framework in place requires the authorities to be aware of the complexity of the process, to have authority established to make decisions, and to delegate responsibility once the broad principles have been determined at the political level".[1]

[1] Remarks by Stanley Fischer First Deputy Managing Director International Monetary Fund Seminar on Policy Challenges for the Financial Sector in the Context of Globalization Sponsored by the World Bank, IMF, and the Board of Governors of the U.S. Federal Reserve System Washington, D.C., June 14, 2001

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INTRODUCTION

"We believe that financial crises can be foreseen, their magnitude can be estimated, precautionary steps can be taken to prevent crises, strategic options can be devised and implemented and corrective measures can be taken to lessen the storm's ultimate impact. Leaders with the foresight to observe and react effectively can manage a crisis strategically before, as well as after, a crisis hits."[2]

This Review has its origin in the work going on at European Union level in regard to the prevention, management and resolution of financial crises in the Member States of the European Union. Specifically all member States have been enjoined by the Economic and Financial Committee to put arrangements in place to prevent, manage and resolve financial crises. Secondly member States have been requested to conduct financial crisis simulation exercise to assess the organisational response capability of national competent authorities to any future financial crises that has systemic implications.

This imperative resulted in the preparation of a Black Book by the CBFSAI setting out their views on the arrangements that should be put in place to manage and resolve any systemic financial crisis that may arise in Ireland. Issues in relation to the prevention of financial crises are being dealt with separately mainly in the context of the development of the regulatory and supervisory regime for financial services at European Union level. Lesser financial crises where there are no systemic implications or where the entity is not deemed too big to fail (TBTF) will be the subject of a further exercise. Many of the recommendations made here, will however, have relevance to those situations also. The Black Book exercise is to be welcomed even in its incomplete form. It provides an excellent starting point from which to devise an optimum strategy for dealing with management and resolution of systemic financial crises in Ireland.

The Black Book makes certain tentative suggestions about the role and function which the Department of Finance and the Minister should play in the resolution of a major financial crisis. The Black Book is still being developed so cannot in any sense be regarded as a complete or final work. The major drawback of the Black Book is that it is mainly focussed on the decision-making procedures and devotes no time to the optimum structures and systems that should be put in place to deal successfully with a financial crisis. Furthermore strategy as to how the crisis might be managed and resolved is compressed into one recommendation that the State provide a blanket guarantee to allow the rescue to be effected. The manner in which other key players in the financial system could share in the cost of and the management and resolution of the crisis in not elaborated. For these reasons BFI Division decided to conduct a review of national organisational capability for the management and resolution of a financial crisis.

[2] Dangerous Markets - Managing in Financial Crises. Dominic Barton, Roberto Newell, Gregory Wilson.

Objective of Review

The objective of the Review is to ensure that the Department of Finance and its related bodies are properly prepared to deal efficiently and effectively with any future financial crisis of systemic proportions. Its primary value at this stage is to highlight lacunae in the preparedness of the Irish regulatory, monetary and administrative Systems to deal with a financial crisis. While the focus of the Review is on TBTF failures or systemic failures, many of the recommended changes are applicable also to less systemically relevant crises. The Review will

- Present senior management with a comprehensive overview of the structures, systems, powers and procedures currently available to deal with the management and resolution of a systemic financial crisis;
- Examine the strength and weaknesses of existing arrangements;
- Make recommendations to facilitate optimum decision-making, management and resolution of a financial crisis.
- Recommend that the necessary steps be taken now to put in place the legislation that will allow the Minister and other key actors to take the appropriate decisions in a crisis situation without fear of litigation or of acting ultra vires Ministerial powers or Constitutional provisions.

Rationale for Recommendations

This Review is prepared on the basis that any legal ambiguities arising in the role, function, powers, responsibilities and accountabilities of the key actors should be put beyond doubt before any possibility of a financial crisis arises. It is suggested that the Financial Services Legislation Consolidation / Modernisation exercise be availed of make the necessary legislative change. Rather that adopting a irrationally exuberant view on the possibilities offered by the use of existing powers from a diverse range of sources, a constructively critical stance is taken in relation to identifying fault-lines in the existing structures, systems and processes. In essence the focus is on finding the structural, systemic and procedural weaknesses. To do otherwise would be to expose the Minister and the Secretary General to an unacceptably high risk level of risk in regard to the general discharge of their macro-economic management responsibilities and accountabilities.

Methodology

Our choice of methodology for the Review was motivated firstly by a desire to move away from precedent-based or perceived self evident 'We know best' decision-making approaches. A second emphasis is to provide evidence-based solutions and to identify and introduce internationally accepted analytical frameworks and best practice.

The Review takes an organisational development approach to crisis management and resolution and adopts two principle tools from the organisation development

repertoire. These are a vertical role analysis and a horizontal 'process engineering' look at the decision-making process.

Vertical Role Analysis

The vertical Role Analysis looks at the Role, Functions, Powers of each key player in the management and resolution process. It aims to identify any gaps in the statutory roles, functions and powers of the key players. It also examines what role the private sector can play in the resolution and management process. A subsidiary aim is to identify the strategies, structures and systems that would be necessary to lock the private sector into the response mechanism in advance of any major financial crisis happening. Burden sharing in relation to the cost of resolving a financial crisis is also considered.

Horizontal examination of decision-making process

A process analysis has been undertaken in regard to each step in the decision-making process. The analysis is designed to

- establish the critical steps in the decision-making process;
- test for any weaknesses in the perceived role, function, powers and responsibilities of key actors;
- identify the essential variables at each decision-making step;
- identify the analytical decision-making frameworks that would summarise in readily assimilable form the main features of the financial crisis and its wider economic and social impacts; and
- ensure that the decision-making procedure observes the fundamental principles of the separation of powers set out in national legislation.

Structure of Review

The report comes in thee parts as follows.

Part 1: This is the main body of the report entitle '*Review of* National Organisational Capability for the Management and Resolution of Systemic Financial Crises' in Ireland. This Part at the structures, systems, procedures and analytical tools that should be available to the Minister to respond to a systemic financial crisis. It examines the following major themes in detail:

Section I: deals with a number of thematic considerations under the heading: Theoretical, Conceptual and EU Competition Considerations. It considers what is meant by financial stability, examines the stages in a financial crisis and provides a summary of EU Competition law applicable to rescue operations launched by Member States to resolve financial crises. It also examines the utility of the moral hazard and constructive ambiguity in the preparation of in the

preparation of a financial crisis management and resolution framework;

Section II: looks at financial crisis resolution precedents from at home and abroad. In particular it will examine the lessons arising from the management and resolution of the financial crisis arising from collapse of the Insurance Corporation of Ireland in 1985. An alternative scenario is presented by examining the macroprudential structures and systems in place for the management and resolution of financial crises in the United States of America.

Section III: considers contextual and situational issues including the Characteristic of the Irish Financial System and the changes in the System Architecture. It looks at the changes to the overall governance and accountability structures that have been put in place since the last major financial crisis in Ireland. It suggests that a paradigm shift has occurred in the accountability framework. The contextual backdrop therefore provides the appropriate scenery against which the role, responsibilities, duties and accountabilities of the key actors can be analysed.

Section IV: examines the role, functions of, powers and accountabilities of key players with particular emphasis on the identification and amelioration of any gaps. It also discusses the principles that should inform the Government's involvement in the management and resolution of financial crises.

Section V: highlights a number of issues in which the Department of Finance will play a critical role and the preparations necessary to enhance its effectiveness in discharging those responsibilities.

Section VI: sets out the recommendations for future action arising from the Review. They include a wide range of legislative change to allow maximum flexibility and an appropriate mix of interventions to be taken in relation to

Single events threatening financial stability i.e. the collapse of a single financial institution;

More *generalised systemic problems* where interventions may be required across the system.

Part 2: Analyses the inter-institutional procedures for cooperation and decision making in the management and resolution of a financial crisis as they currently stand and makes a series of recommendations for the future.

This Part describes in broad terms the parameters of the existing decision-making process in relation to the management and resolution of financial crises. It goes on to

envision what elements an optimum financial crisis resolution decision-making process might look like.

It then undertakes a forensic examination of each node of the proposed new financial crisis management and resolution process under six generic headings:

- Objective
- Key Player
- Clarity of Role and Function of Key Player
- Efficacy of Systems and Processes
- Action Necessary to Remedy Perceived Deficiencies
- Action by Department of Finance

The examination of the decision-making process follows the strategic framework for financial management and resolution identified by Stanley Fischer of the IMF but ahs been adapted to Irish circumstances. The rest of this Chapter is accordingly structured on the following basis.

Stages of Financial Crisis Management and Resolution	***No. of Discrete Decision Points at each Stage***
Financial Crisis Identification and Confirmation Stage	6
Stabilisation Stage: Developing the Financial Stability Programme – Tier One Decisions	11
Confidence Building Stage: Public Relations and Communication Strategy	7
Restructuring Implementation Stage – Tier Two Decisions	10
Final Recovery Stage	5
Total Number of Critical Decision Points	39

The focus is on building pre-programmed supports to support optimum decision-making at the time of crisis. The Review therefore will be precise and specific about what structures, systems and processes should be in place but will simultaneously preserve maximum flexibility in relation to the response mechanisms chosen at the time of financial crisis.

This Part concludes that the work to date also suggests that

- certain administrative arrangements and decision-making structures should now be put in place;
- legislative powers should be clarified in order to facilitate the optimum decision-making;
- necessary powers to allow the Minister to act should be put beyond doubt in the form of specific legislation to allow the Minister or his agents to provide liquidity, grants; guarantees; take equity participations or to acquire an insolvent banking institution where the threat to financial stability would warrant such action;

- National strategy should be informed by the developments at European Union Level.

Part 3: Contains a series of appendices containing extracts from the extensive research material and background data consulted as part of the Review.

Cultural and Strategic Considerations

It is not surprising that a review of this nature should throw up some issue where tradition, precedents and culturally-driven attitudes may seek single purpose solutions to multidimensional problems. A number of such issues have arisen in this Review and are discussed briefly in the following paragraphs. A more thorough-going analysis of the value of certain constructs is provided in the body of the Review itself. Our view is that the nature of the game has changed profoundly and multifaceted and complex responses will be required for the future.

Secondly, the evolution and development of the financial services legislation in Ireland has only in recent years been subject to sustained and strategic reform. This review identifies a further need to clarity in legislation the boundary of the role, responsibilities and accountability of the Minister for Finance in the financial services sector.

A number of brief observations are provided on such topics in the following paragraphs

1. Underlying Assumptions in Black Book

- A number of underlying assumptions in the Black Book are worthy of note. These are;

    i. The time constraints placed on the key decisions makers in the Department are set in terms of hours not days or weeks! This is a function of the rate of technological development in the markets.

    ii. The Black Book is based on the assumption that, at least the two major players in the Irish retail banking market are too big to fail. Other second tier organisations will be stress tested by the CBFSAI to determine whether they are too big to fail.

    iii. The expectation on the part of the CBFSAI is that the Minister for Finance will commit substantial (but unquantified) funding to the ailing enterprise on the basis of incomplete information (also perhaps presented in a self-serving way) presented by the Chairman and CEO of the ailing bank.

iv. CBFSAI envisage that an immediate commitment of public money will be made in the form of a letter of comfort or State guarantee issued by the Minster for Finance within hours of the alert of the impending crisis. At which point no clear analysis of the situation is available.

v. There are no suggestions as to how and to what degree the private sector should be involved in funding the resolution of any financial crisis.

- The Review examines the relevance and sustainability of these assumptions in the light of prevailing regulatory, prudential, governance, accountability and parliamentary practices in the course of its analysis of optimum response mechanisms. A number of preliminary comments are however appropriate

  i. If the underlying assumption is that the two big players in the Irish market are TBTF is left unchallenged it will mean that over 80% of the Irish Bank Sector is deemed to big to fail. Ab initio, this raises issues of concentration and fundamental questions about the efficacy of competition policy as it applies to the Banking sector. Issues of equity also arise as to why 'uninsured depositors' with smaller entities not of systemic importance should not be protected.

  ii. As CBFSAI is statutorily responsible for the maintenance of the payments system, the health of which would be a critical part of any decision matrix, it would be critical to ensure that the CBFSAI and IFSRA are put into the position of having to take the lead role in regard to advising the Minister in regard to the crisis and to clearly recommend a way out of the impasse.

2. ***Constructive Ambiguity***

Considerable time and attention is devoted in the Review to the concept of constructive ambiguity, mainly because, it is not a readily understood concept. Intuitively, ambiguity on its own could hardly be described as being constructive. Secondly, constructive ambiguity is a bedrock concept, the acceptance or rejection of which has profound implications for the direction of policy. Thirdly, on forensic examination, the concept has been found to have two apparently contradictory effects. It may be relevant in the context of the CBFSAI's posture in regard to the provision of liquidity assistance in any set of prevailing circumstances. The Review, however, demonstrates that its application to the question of establishing structures, systems and procedures to deal with any future financial crisis may be contrary to the national interest and damaging to the long-term health of the banking system.

3. *Clarity of Strategic Role of Minister in relation to Financial Services*

- An unanticipated outcome of the Review is that there is no specific role specified in the financial services legislation for the Minster for Finance in regard to financial stability. The Ministers and Secretaries Act, 1924, is also silent on the issue. This Review will recommend that this deficiency be made good.

- What is even more curious is that neither the legislative codes for financial services or the Ministers nor Secretaries Acts *specifies the role of the Minister for Finance in relation to financial services generally*. It is not apparent that any other body or code of legislation does either.

- A part explanation for this state of affairs may be found in the legislative drafting conventions that have to date tended only to specify the Minister's role, functions, powers and responsibility within the confines of specific pieces of legislation. The strategic and general role, function and powers of the Minister in relation to financial services overall seem to have got lost in the specificity of industry and sectoral codes of legislation.

- It is suggested that the point is of some significance and that his responsibilities in relation to domestic and international financial services be unambiguously established.

Stress Test / Pilot Project

As indicated earlier, the European Union requires member State governments to undertake a pilot study to stress test the ebullience of their financial crisis management and resolution systems. In exercise of this requirement, the BFI approach was to conduct a review of the structures, systems and procedures that can currently be relied upon for this purpose. At an early stage it became apparent that a number of shortcomings were evident at the structural, systemic and decision-making levels. These lacunae have now been confirmed to be of such significance as to render any procedural pilot exercise of dubious value. It is recommended that the pilot exercise would have much more meaning and relevance when policy decisions have been taken in relation to the structural, systemic and procedural issues identified in this Review. It may be purely coincidence that the date for the EU pilot test has also been deferred until spring 2006.

Motivation

The particular in-depth approach to this project was motivated by a number of primary influences. The first was the statement by the former Secretary General of the Department of Enterprise Trade and Employment at the Departmental Conference on the importance of using the Regulatory Regime as a means of improving competitiveness. Second was the endorsement of this concept by the Senior Management Team at the Departmental Conference. Thirdly the Secretary General at the Division's meeting with the MAC stressed, in particular, the importance of the competitiveness indicator as we embarked on modernising the regulatory regime for financial services. Furthermore the Secretary General has repeatedly stressed the need to conduct and assessments of the major risks facing the Department.

The Recommendations

The recommendations in this Review if implemented are consistent with the advancement of Ireland further up the International Capital Market Development Indices. Secondly they will help minimise the financial costs of managing and resolving financial crises to the private and the public sector. They will finally help ameliorate the potential economic fallout from such an event.

Mr. Paul O'Brien, now with OPW and Mr. Declan Cahill provided valuable assistance in completing this project.

____

Finbarr Kelly,
BFI Division,
20 May, 2005

HIGHLY CONFIDENTIAL

Outline Heads of a Bill to provide for the Irish Authorities (Minister for Finance) to take action in relation to an Irish financial institution to:

(i) **take into public ownership of, and**

(ii) **possible provision of a guarantee in respect of a distressed credit institution**

Purpose

(Long Title?)

The purpose of the Bill is to give the Minister for Finance power to transfer the ownership of a particular distressed credit institution[1] authorised to operate in Ireland (the institution is referred to as 'Xfi' in these heads). The Bill should provide that the Minister may transfer the securities (including shares) [or business][2] of a particular credit institution into public ownership, i.e. to the Minister for Finance.

~~[Questions:~~

- ~~Should provision also be made to provide power to transfer ownership to another body in the public or private sector?~~
- ~~Should provision be made to provide power to transfer ownership of a building society to a public/private body or Minister for the Environment, Local Government and Heritage (or Finance)?]~~

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The Bill is also to provide that the Minister may also transfer a credit institution brought into public ownership back to the private sector. [Has the CBFSAI power to give financial assistance Irish registered building societies?].

The Bill may also need to provide for necessary or consequential provisions as follows, but should in any event provide a specific power for the Minister for Finance to directly appoint ~~,~~ and remove directors of Xfi so that he can ensure a level of control and influence over the operations of the company, consistent with the directors' statutory and fiduciary duties to the company~~i.e~~.:

- Delisting of shares in the Xfi as well as enabling the Minister to remove and appoint directors, and make other modifications of the rules for holding of meetings of the company.
- Extinguishing of the existing share options
- Providing for the any amendment necessary in consequence of the impact of transfer of ownership on rights or obligations of lenders, bondholders, swap counterparties or suppliers which would be triggered by the act of bringing the financial institution into temporary public ownership. (Apparent from UK NR legislation that a range of contractual arrangements that NR had previously

[1] 'Credit institution' as defined in regulation 1 of the European Communities (Deposit Guarantee Scheme) Regulations 1995 [SI 168 of 1995] i.e. "… an undertaking other than a credit union or friendly society whose business it is to receive deposits or other repayable funds fro the public and to grant credit on its own account. This definition encompasses both banks and building societies.

[2] The UK Banking (Special Provisions) Act 2008 refers to 'securities' of an institution and seems to differentiate these from the 'business' (e.g. property, rights and liabilities). However, the Northern Rock plc Transfer Order 2008 made under the Act is concerned with only the transfer of shares to the Treasury Solicitor. No order has yet been made under the UK Act in relation to transfer of property, rights and liabilities.

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