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REPORT of the Joint Committee of Inquiry into the Banking Crisis

Houses of the Oireachtas
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THEME: C2

**Role and effectiveness of the Policy appraisal
regime before and during the crisis
Pre Crisis phase**

LINE OF INQUIRY: C2b

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

President Jean Claude Trichet
European Central Bank
Kaiserstrasse 29,
60311 Frankfurt am Main
Germany

14 November 2008

Dear President Trichet

Thank you for your letter of 16 October to An Taoiseach regarding the Credit Institutions (Financial Support) Scheme 2008 and in particular the inclusion of interbank deposits with a maturity of up to three months as covered liabilities under the Scheme.

At the outset, it is important to stress that your letter was received subsequent to the approval of the Scheme by the European Commission the preceding weekend and its presentation to the Irish Parliament for approval was already listed for the next day. The parliamentary process to provide legal certainty in relation to the guarantee provided by the Government to the Irish banking system did not allow for any amendment to the Scheme to be taken. In addition, further discussions with the European Commission would have been required which we understand could have necessitated re-notification of the Scheme and would in any event have given risen to further delay in finalising its status.

In addition, notwithstanding the strong desire of the Irish banks to obtain more secure longer-term funding, credit market conditions were such that there was a high degree of reliance on interbank deposits of a relatively short maturity for meeting their ongoing liquidity needs. In this context, there was a concern that any change in the scope of the guarantee at a late stage could impact adversely on the liquidity and stability of the Irish banking system and indeed on the credibility and reputation of the guarantee overall.

The Irish authorities strongly share your concern regarding the importance of ensuring that national measures do not create distortions in the euro area money market or the implementation of euro area single monetary policy. In establishing and implementing the Scheme I have been acutely conscious to ensure that the Irish Scheme does not give rise to any such issues. Consequently when I invited the eligible credit institutions to join the Scheme on 22 October, I emphasised to them the importance of ensuring that their institution's recourse to interbank deposits with a maturity up to

three months was balanced and proportionate with its overall funding needs so as to ensure consistency with the management of liquidity by the Eurosystem and compatibility with its operational framework. My Department highlighted this important issue as a key requirement of the Scheme in bilateral meetings at CEO level with the participating credit institutions on 7/8 November last and it has been included as a specific requirement for ongoing reporting by the covered institutions under the Scheme.

I wish to advise you that each of the relevant credit institutions has assured my Department that it is a particular priority for them in terms of their funding strategy overall to seek to secure longer-term debt financing with the support of the Government's guarantee and to progressively reduce their dependence on shorter-term interbank deposits over time.

I also wish to confirm that my Department, liaising closely with the Central Bank and Financial Services Authority of Ireland, will closely monitor the banks' recourse to shorter-term interbank deposits over the coming months. The Irish authorities will of course act quickly to address any risk that the Irish segment of the euro area money market is subject to any substantial distortion on account of excessive short-term debt issuance based on the broad nature of the guarantee provided under the Irish Scheme.

I trust that this information alleviates your concern regarding this matter. I will of course keep you advised of any relevant developments in this area, in the context of the review of the Scheme to be carried out after six months.

Yours sincerely

BRIAN LENIHAN

Brian Lenihan TD
Minister for Finance

cc An Taoiseach, Mr. Brian Cowen TD

Mr. John Hurley, Governor of the Central Bank and Financial Services Authority of Ireland

CONFIDENTIAL**Financial Stability Issues – Scoping Paper****1. Introduction**

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

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

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

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

expectations of their actions. It may also condition or influence public perceptions of the likelihood of a financial stability event.

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

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

If an institution is experiencing liquidity difficulties¹ and has exhausted any opportunities for accessing liquidity in the wholesale market the first step should be for it to seek liquidity from the European Central Bank (ECB) in normal operations. This liquidity would of course require eligible collateral. In Ireland, a large proportion of banks balance sheets can be used as collateral for liquidity provision; through for example the use of mortgage backed promissory notes. Intensive use of eligible assets for liquidity under “normal” Eurosystem conditions is likely to be noticed by the market. If this liquidity is not sufficient to restore liquidity to the institution, the institution may approach the CBFSAI for emergency liquidity assistance (ELA). The view of the CBFSAI is that the requirement for the ELA provision to an Irish bank would signify the existence of a serious threat to the long-term sustainability of the financial institution in question because of the ‘stigma’ that would attach to it. It is important to highlight, therefore, that ELA provision would be an interim measure while urgent consideration was given by all parties to the available options for rescuing the bank.

3.1 CBFSAI role in this situation

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

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

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

3.2 Department/Minister's role in this situation

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

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

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

3.3 Impact of ELA provision on confidence in the institution

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

In circumstances that there may be specific concerns regarding the position of the financial system as a whole in Ireland, on account, for example, of its dependence on property related lending, a further effect of ELA provision on confidence in the financial sector may take place in international wholesale markets, as other banks lose confidence in an

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

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

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

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

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

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

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

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

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

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

- **The Takeover Code**

This legislation forces takeover bids to be disclosed and sets out a long procedure for takeovers – the Governor of the Bank of England, Mr Mervyn King, said that this prevented him from organising a takeover and presenting it as a “done deal”

- **The Market Abuse Directive**

This defines what behaviour is considered insider dealing and provides for disclosures to the market – Mr King said this meant that any lending operations to Northern Rock had to be disclosed.

- **The insolvency regime in the Enterprise Act 2002**

This provides a framework for the winding up of companies – for banks it means that depositors have their accounts frozen. Mr King said that this made it rational for people to queue for their deposits back

- **The Financial Services Compensation Scheme**

This sets out the rules for the limited guarantees on UK banking deposits – Mr King said that the fact that this only covered up to £35,000 made it more important for people to withdraw their money from Northern Rock.

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

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

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

Given the importance of the principle of the precedence of private sector solutions, the first decision is whether the State should take any action to assist an institution at risk of insolvency. Responsibility for maintaining the solvency of an institution lies with its Directors and shareholders should try to ensure that any institution they invest in is solvent

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

4.1 Definition of systemically important institution (TBTF)

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

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

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

4.2 Role of CBFSAI if an institution is insolvent

It is important to note that the CBFSAI is legally prohibited from providing ELA to an insolvent institution. As referred to above, it will be difficult particularly in a crisis situation to differentiate clearly between an illiquid and an institution at risk of insolvency. In any event an illiquid institution can quickly become insolvent. It is therefore essential that

there is close co-operation, co-ordination and communication between the three institutions comprising the DSG to ensure that the tools available to manage a crisis situation are effectively deployed in a crisis situation.

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

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

4.3 Role/Legal powers of the Minister in this situation

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

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

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

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

would not be sufficient for the CBFSAI to lend to an insolvent institutions – a comprehensive guarantee would be necessary.

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

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

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

4.4 Principles guiding public intervention

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

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

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

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

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

Common Principles for cross-border financial crisis management

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

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

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

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

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

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

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

Appointment of a receiver for all or part of the assets

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

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

There are three form of winding up:

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

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

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

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

- in the interests of depositors.

Liquidation has a number of practical effects:

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

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

Appointment of an Examiner (Court Protection)

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

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

Critical Banking Functions

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

The recent UK discussion paper 'Banking reform -- protecting depositors -- indicates there different approaches to resolving bank difficulties in other countries. The US has a distinct insolvency regime for banks involving wide powers for special administrators appointed to

carry out resolutions. These special administrators are generally answerable to the banking regulator rather than the courts. Bridge Banks involves either the transfer of the assets and liabilities of the existing legal entity to a new legal entity or the transfer of the existing legal entity to new openers. The new (bridge) bank would then continue to provide the critical banking functions while either a recapitalisation or a permanent transfer of business to new owners was organised. Some European countries have special arrangements for banks in trouble including provisions for authorities to appoint special or provisional administrators with discretion over the initiation of measures, including the ability to apply them to banks before they are technically insolvent.

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

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

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

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

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

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

State Aid and Northern Rock

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

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

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

4.7 Deposit Guarantee Scheme:

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

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

An issue arises as to how a payout of the scheme would be funded. Currently the DGS stands at €455 million. However it is likely that the requirement to compensate depositors would be greater than this figure. There is a requirement in the Deposit Guarantee Directive Regulations on the CBFSAI to pay all eligible depositors. The CBFSAI have therefore concluded that it is implied that if the DGS is not sufficient to meet the loss amount the CBFSAI must meet the balance. The Regulations allow the CBFSAI to go back out to credit institutions and seek additional contributions. It is considered though that these contributions are limited to the initial amount in the fund. It is unclear whether, if more than

twice the current value of the fund was required, the CBFSAI could or should cover the balance. The question also arises of the pace at which participating credit institutions would be in a position to replenish the DGS fund and the implications for maintaining the attractiveness of Ireland as an investment location for banks, since they can provide services from abroad on a broad basis.

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

The two possible uses of the DGS identified are:

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

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

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

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

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

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

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

Urgent Next Steps

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

Company Law intervention Mechanisms

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

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

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

Appointment of a receiver

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

Appointment of a liquidator

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

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

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

Members and creditors voluntary winding up

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

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

Compulsory winding up under a Court appointed liquidator

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

6 The CBFSAI is entitled to prior notice and a hearing in relation to any petition to wind up a bank. The Bank may also petition for the winding up of a bank on four grounds i.e. that it may be unable to meet its obligations to creditors, has failed to comply with a direction under S21 of the CBA 1971, has ceased to carry on banking, or in the interests of depositors. Where a bank is being wound up voluntarily the Bank may also apply on these grounds to have it wound up by the Court (S48 CBA 1989). The Bank has similar powers in relation to Building Societies (S 109 BSA 1989).

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

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

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

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

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

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

Appointment of an Examiner (court protection)

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

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

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

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

13 The examiner has 2 principal functions:

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

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

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

Appointment of Inspectors or intervention of the Director of Corporate Enforcement

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

Structural Changes to the Company

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

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

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

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

Stock Exchange considerations

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

Some Tentative Assumptions and Conclusions

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

- *Where the institution is substantially viable (or has a significant "goodwill value") a market solution (takeover or merger) may be the preferred option or the target of any short term intervention.*
- *Company law intervention would of its nature only form part of any package to assist a troubled financial institution, and would probably accompany or follow measures to support its liquidity.*
- *The Court Protection (Examinership) procedure seems to offer the least difficulties and most advantages of all the procedures except possibly in the case of dire insolvency.*
- *If Court Protection is recognised as the most useful of the tools available there may be scope for fine tuning aspects of the legislation governing the initiation of the process (e.g. use of CBFSAI data) to render it more user friendly.*
- *It is doubtful if an effective form of support or supervisory action (intermediate between short term liquidity support and company law intervention) could be devised which would enable a credit institution to continue trading in a normal or near normal manner.*
- *There is a need to explore further the nature of deposits as liabilities of a credit institution and the related question of when or if a liquidity problem affecting their repayment on time would constitute insolvency (as in unable to meet liabilities as they fall due).*

Goodhart approach to deposit protection

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

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

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

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

from US - work in progress
2/19/08

STRICTLY CONFIDENTIAL - SUBJECT TO CHANGE



Discussion Materials Regarding Strategic Options

Draft Working Paper

21-Sep-2008

Due Diligence Update



Working with management for the last 10 days

Situation has developed rapidly

- Continued speculation has driven significant outflows
- Liquidity situation has deteriorated materially
- Discussions with:
 - CEO and Chairman
 - CFO and Treasurer
 - Lending Directors
 - Credit Personnel
 - Finance Personnel
 - Auditors
 - Lawyers
- Received fulsome flow of information
 - Data gathering continues
- Initial review of Top 60 commercial loans
 - Discussions with management
 - Further data request being processed
 - Information being updated {e.g. latest third party valuation and management estimated valuation of collateral}

Scope of Work



GS Role: lead a review of Harmony's current financial position with input from harmony legal and accounting advisers as required. Recommend and co-ordinate specialist advice where appropriate (public relations, rating agency interaction, real estate valuation/surveyor)

- Analysis of Commercial Assets
 - Characteristics of commercial mortgages, by loan (counterparty, real estate asset, latest valuation, loan status, expected redemption)
 - Potential funding structures and quantum available through third party financing (banks, ECB)
 - Sensitivity analysis based on indexation benchmarks by vintage, where appropriate
 - Comparable loan sales, where available
 - Implications of read-across from other lenders, research analysts
 - Potential update of latest surveyor valuations, if relevant
- Analysis of Residential Mortgages
 - Characteristics of residential mortgages by portfolio
 - Potential funding structures and quantum available through third party financing
 - Sensitivity analysis of portfolios based on indexation benchmarks by vintage/loan type
 - Comparable loan sales, where available
 - Implications of read-across from other lenders, research analysts
- Analysis of other assets
- Characteristics of liabilities
 - Maturity profile
 - Characteristics of deposit balances
 - Sensitivity analysis on deposits
 - Sensitivity analysis on liquidity reserves
 - Characteristics of liquidity reserves
- Review of credit agency commentary and actions relating to Harmony
- Potential options available to Harmony and execution mechanics
 - Overview of potential financing sources
 - Execution plan for financing alternatives (timing, interaction with rating agencies, interaction with potential lenders, co-ordination with other advisers (accounting/legal/valuers), legal restrictions)
 - Overview of all strategic options, including acquirors/investors
 - Co-ordination/execution of merger/investment discussions
 - Overview of contingency planning measures, controlled scenario and response to deposit run
 - Execution plan for contingency planning actions (interactions with key constituencies, review with legal team of potential implications on capital or corporate structure (regulatory exit, Ireland, change of control, ratings triggers etc), implementation plans)
- Review is based on available information and limited timeframe: not conducting full due diligence on Harmony. Matters excluded from the scope of work would include
 - Audit of or opinion on financial position of Harmony
 - Independent valuation or appraisal of the assets, collateral and/or liabilities of Harmony or impairments to be taken
 - Opining on the adequacy of provisions, capital, risk levels and/or risk management
 - Provision of investment advice

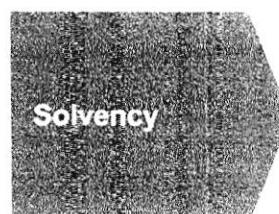
Overview of Current Situation (1/2)



- Pre-recent outflows, Harmony had sufficient liquidity to cover scheduled wholesale maturities until the end of 2009
- Current level of outflows have been substantial and are putting a considerable strain on liquidity
- Net outflows since the 5th of September of c. €868m are equal to ~20% of liquid assets at the end of August 2008

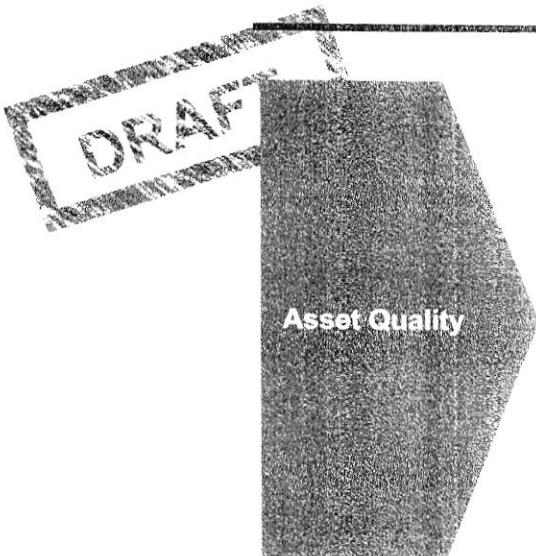


- Harmony is essentially unable to access the unsecured debt markets for liquidity
 - However, by securitising its residential and commercial property portfolios, we estimate it could access up to c.€1.7 - €2.5bn of liquidity on a term basis
 - This would encumber almost all the company's balance sheet which we do not believe would be accepted by the regulator or rating agencies as it would structurally subordinate depositors and unsecured lenders



- Although most of the company's capital is core Tier 1, any loan write offs that take Harmony close to the 8% total capital ratio (Under Basel II) would have to be replenished by equity given public Tier 2 markets are closed to Harmony
- This gives the company scope for impairments of up to ca. €700m before it would suffer a regulatory capital shortfall under Basel I (equivalent to c.7.5% of commercial book combined with c.3.5% of residential book)

Overview of Current Situation (2/2)



- Nature of loans are very bespoke and specific
- Harmony believes the loan book is secured by the underlying collateral and the nature of its borrowing customers
- Harmony recognises that the specific nature of its loans makes an "outside-looking-in" assessment extremely challenging
- Management's view is that while some specific loans may have a risk of not being fully repaid in relation to specific projects, they believe that true cooperation with the borrowers and orderly workout of the loans, repayment can be achieved overtime
 - This may be achieved through a combination of valuing the underlying loan, cross-collateral and personal guarantees from borrowers
- For a number of loans, full repayment will not be achieved
 - From discussions with management indicated losses will materialise from a number of specific loans
- It is not possible at this point to ascertain the extent, depth, quantum and timing of potential losses

Illustrative Regulatory Capital Stress Testing

Indicative Regulatory Capital Impact of Various Loan Book Write Offs / P&L Provisions

Impact of Various P&L Provisions



Regulatory Capital Position vs. Regulatory Requirement

	As of 31-Aug-2008	
	Base	Basel II
Capital		
Tier 1 (excl. earnings to be audited)	1,365	1,362
Eligible Tier 2	469	471
Total Regulatory Capital	1,834	1,834
RWA		
RWA	11,798	15,625
Ratios		
Tier 1	11.6%	8.7%
Total Capital Ratio	15.5%	11.7%
Minimum Total Capital Requirement	10.0%	8.1%
Headroom over Reg. Requirement	650	561
Earnings 8M 2008 (to be Audited)	119	119
Headroom over Reg. Requirement (incl. Earnings)	770	680

Capital Headroom/(Shortfall) Relative to Regulatory Requirement at Various Loan Book Write Offs

Residential Loan Book Write-off	Total Capital Impact Post-Tax				
	0.0%	4.0%	5.0%	6.0%	7.0%
0.0%	267	349	431	513	594
1.5%	277	359	441	523	605
2.0%	288	370	452	533	615
2.5%	298	380	462	544	626
3.0%	309	390	472	554	636

Selected Capital Impacts	267	359	452	544	636
Capital Generation (Earnings ¹)	15	15	15	15	15
Net Capital Impact	252	344	437	529	621

Pre Write-off Capital Headroom (excl. Earnings to be Audited)	650	650	650	650	650
Basel I	650	650	650	650	650

Pre Write-off Capital Headroom (incl. Earnings to be Audited)	770	770	770	770	770
Basel I	770	770	770	770	770

Post Write-off Capital Headroom (excl. Earnings to be Audited)	398	306	214	121	29
Basel I	398	306	214	121	29

Post Write-off Capital Headroom (incl. Earnings to be Audited)	518	425	333	241	148
Basel I	518	425	333	241	148

Post Write-off Capital Headroom (excl. Earnings to be Audited)	429	336	244	151	59
Basel II	429	336	244	151	59

¹ Retained earnings for the period Sep 2008 (based on actual amount for the first 8 months of 2008)

Indicative Mark-to-Market of the Commercial Loan Book

Sensitivity Analysis of Loan Book Mark-to-Market as % of Par Value

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	1	Loans Weighted Average Life (# of years)			
		2	3	4	5
15.0%	85.5%	74.1%	64.3%	55.7%	48.2%
17.5%	83.3%	70.1%	58.5%	48.5%	39.8%
20.0%	81.1%	66.0%	52.8%	41.4%	31.5%
22.5%	78.9%	61.9%	47.1%	34.3%	23.1%
25.0%	76.8%	57.9%	41.4%	27.1%	14.7%

- Two of the key drivers of the mark are the interest rate differential between the yield on the loan book and the yield on comparable traded CMBS, and the number of years this differential is in force (i.e. the duration of the loan)
 - Many of the loans in the top 30 exposures file have an average maturity of circa 1.5 years
 - In the current environment we would expect the redemption profile of these loans to be extended
 - This will impact the mark-to-market and also the ability to pledge as collateral

Illustrative Liquidity Sufficiency Analysis

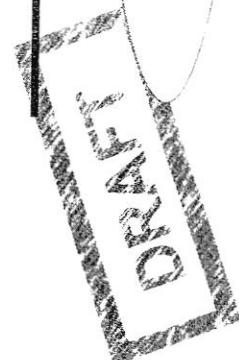
Illustrative Analysis of Various Levels of Retail Deposit Outflows



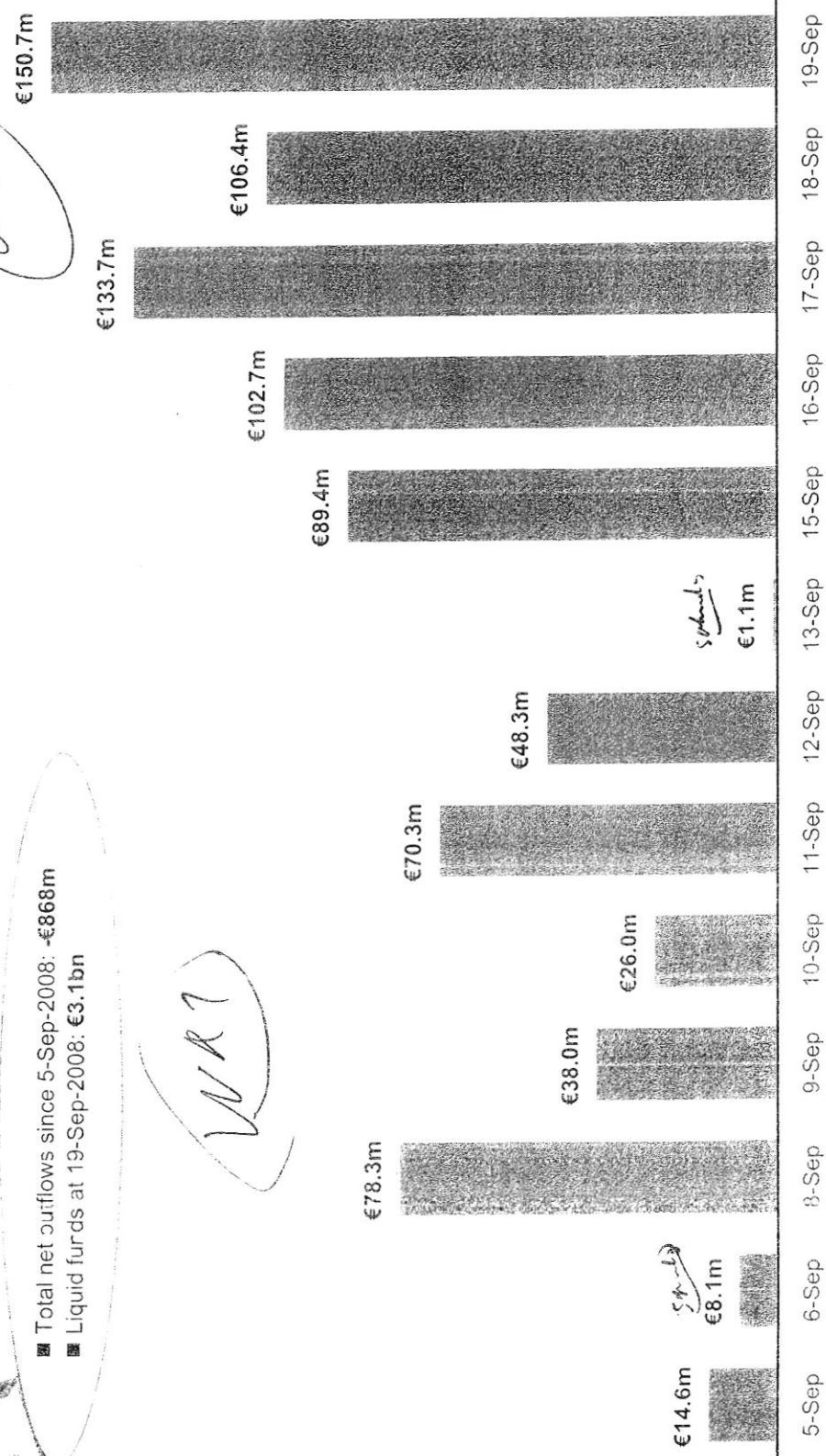
	Liquid Assets Balance at 19-Sep-2008 (€m)	Daily Deposit Outflows (€m)					
		25	50	75	100	125	150
Implied # of Days Before Estimated Liquidity Sufficiency Level Breached							
Liquid Assets Balance at 19-Sep-2008 (€m)	3,077	42	21	14	10	8	7
Funding Liabilities (€m)	13,565						
Liquidity Availability as % Funding Liabilities		23%					
Estimated Liquidity Sufficiency Level		15%					
Headroom/(Shortfall)		8%					
Headroom/(Shortfall) in €m	1,042						

- Starting Liquid Assets Balance equal to €3.1bn
 - This balance is pro forma from the 5th of September deposit outflows of €868m (at 19-Sep-2008)
 - This implies a current liquidity ratio of 23% vs. 15% estimated sufficiency level
- Current Headroom vs. estimated sufficiency level equal to €1.0bn
- If net daily deposit outflows totalled €25m, the estimated sufficiency liquidity level of 15% of Funding Liabilities would be breached in ~42 days
- If net daily deposit outflows totalled €150m, the estimated sufficiency liquidity level of 15% of Funding Liabilities would be breached in ~7 days

Funding Liquidity Situation



- Total net outflows since 5-Sep-2008: -€868m
- Liquid funds at 19-Sep-2008: €3.1bn



Source: Management Information
Note: Caution: rounding errors and data consolidation errors occur

Illustrative Liquidity Analysis

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Level of Required Funding	1,000	2,000	3,000	4,000	5,000	6,000	7,000	7,500
Government								
Loan as of Available Collateral (€11.8bn)	8.5%	16.9%	25.4%	33.9%	42.4%	50.8%	59.3%	63.8%

Ability of Res. Loan Book to Generate AAA RMBS (1/2)



- Harmony could securitise (or create a covered bond programme against) its residential loan book to generate triple-A securities that could be pledged as collateral to a funding provider or the European Central Bank (ECB)
- In order to create triple-A securities which might appeal to 3rd party funders we would recommend applying the following minimum criteria (i.e. exclusions) to the portfolio:
 - Loans with more than 30 days in arrears are excluded
 - Loans with at least one missed payment in the last 12 months are excluded
 - Loans with LTV higher than 85% would be haircut back to that level
- To achieve a triple-A rating for the securities, an appropriate amount of credit enhancement or subordination will be required. In the current negative house price environment we would expect this subordination to be in the region of 15% - e.g. EUR 100m of qualifying loans would generate EUR 85m of AAA securities
- Once the triple-A securities have been created they could be pledged as collateral to a funding provider whether to ECB or third party providers. These counterparties will require haircuts in the following range :
 - ECB: 3% haircut (pre February 2009)
 - ECB: 16.4% haircut (post February 2009)
 - Third-Party Bank: 25%-35% haircut

Ability of Res. Loan Book to Generate AAA RMBS (2/2)

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Ability to Generate AAA RMBS - Example	
Collateralised Assets	£m
Residential Loan Book @ 31 Aug 2008	2,390
Assets Pledged to MBPN Programme	(748)
Eligible Assets post MBPN Programme¹	1,642
Funding Raised	£m
Eligible Assets post MBPN Programme	1,642
Exclusions ² as % of Eligible Assets post MBPN Programme	17.3%
Exclusions ²	284
Eligible Loan Book	1,358
% of Loans that Create AAA RMBS	85%
Volume of Collateralised AAA RMBS	1,154
ECB Haircut to AAA RMBS	
- Pre Feb-2009	3%
- Post Feb-2009	16%
Funding Raised by Pledging AAA RMBS as Collateral	
- Pre Feb-2009	1,120
- Post Feb-2009	965

Potential Volume of AAA RMBS							
Potential Volume of AAA RMBS Collateralised by Residential Loan Book							
		Deductions as % of Eligible Loan Book					
		17.3%	25.0%	30.0%	35.0%	40.0%	
% Loans That Generate AAA RMBS		75.0%	1,018	924	862	800	739
		80.0%	1,086	985	920	854	788
		85.0%	1,154	1,047	977	907	837
		90.0%	1,222	1,108	1,034	961	887
		95.0%	1,290	1,170	1,092	1,014	936

Residential Loan Book Indexed LTV Stratification				
LTV Band	Residential Loan Balance in Band	% of Total Residential Loan book		
		Residential Loan book	Cumulative %	
>95%	367	15%	15%	
>90%	92	4%	19%	
>80%	302	13%	32%	
>70%	302	13%	44%	
>60%	318	13%	58%	
>50%	240	10%	68%	
>25%	459	19%	87%	
<25%	310	13%	100%	
	2,390	100%		

¹ Assuming BNP facility not used.² Exclusions based on: Loans with indexec LTV higher than 85%, loans with more than one month arrears (exclusion based on the percentage on a total loan book basis). No information available on loans with at least one missed payment in the last 12 months.

Potential Funding Raised						
Potential Funding Raised by Pledging AAA RMBS as Collateral (85% LTV)						
		Deductions as % of Eligible Loan Book				
		17.3%	25.0%	30.0%	35.0%	40.0%
ECB Repo						
3% haircut to RMBS (pre Feb-2009)	1,120	1,015	948	880	812	
16% haircut to RMBS (post Feb-2009)	965	875	817	758	700	
3rd Party Bank Repo						
25% haircut to RMBS (min)	866	785	733	680	628	
35% haircut to RMBS (max)	750	680	635	590	544	

Ability of Commercial Loan Book to Generate AAA CMBS (1/2)

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- Harmony could securitise its commercial loan book to generate AAA securities that could be pledged as collateral to a funding provider
- The first step in such a process would require estimating an up-to-date LTV for the €9.4bn commercial loan book
 - For this highly preliminary analysis, we have indexed down the last reported third-party valuation of collateral in the Top 30 Exposures by an amount depending on the year of the valuation
 - We have assumed the year of valuation and LTV stratification for the Top 30 Exposures apply to the entire €9.4bn commercial loan book
- The adjusted collateral values are then used to determine the quantum of AAA securities that could be issued. This quantum depends on the maximum allowed LTV to achieve an AAA rating based on the adjusted collateral amount
 - e.g. if adjusted collateral was EUR 100m and AAA securities required a maximum LTV of 30%, then EUR 100m x 30% = EUR 30m of securities could be created
- The cash advanced by the ECB or other market counterparty against these AAA securities could be between 70% and 85%

Ability of Commercial Loan Book to Generate AAA CMBS (2/2)

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Assessing Eligibility of Commercial Loan Book's Top 30 Exposures Depending on Date of Original Valuation

Valuation Date	Original Valuation Date	Original Valuation Date	Original Valuation Date	Adjusted Value	Original Collateral	Original Amount	Original Advance	Original Advance
				Value	Value	Value	Value	Value
7	1998	1998	1998	10.0%	6	4	60.8%	67.5%
0	1999	1999	1999	10.0%	0	0	76.4%	84.9%
29	2000	2000	2000	10.0%	26	1	4.3%	4.8%
3	2001	2001	2001	10.0%	2	2	88.6%	98.5%
10	2002	2002	2002	10.0%	9	19	193.3%	214.8%
118	2003	2003	2003	10.0%	106	172	145.3%	161.4%
273	2004	2004	2004	10.0%	245	208	76.4%	84.8%
143	2005	2005	2005	20.0%	114	190	133.2%	166.5%
1,507	2006	2006	2006	30.0%	1,055	1,305	86.6%	123.7%
2,489	2007	2007	2007	30.0%	1,742	2,265	91.0%	130.0%
1,283	2008	2008	2008	30.0%	898	954	74.4%	106.3%
5,861					4,205	5,121	87.4%	121.8%

Ability to Generate Funding - Example

Input Variable Example	£m
Adjusted Value of the Collateral	4,205
% of Loans that Create AAA CMBS	30%
Volume of Collateralised AAA CMBS	1,261
Funding 3rd Party Advance Rate	85%
Volume of Collateralised AAA CMBS	1,072

Potential Funding Raised

Funding 3rd Party Advance Rate	Potential Volume of Funding					
	% Loans That Generate AAA CMBS	20.0%	25.0%	30.0%	35.0%	40.0%
70.0%	589	736	883	1,030	1,177	
75.0%	631	788	946	1,104	1,261	
80.0%	673	841	1,009	1,177	1,346	
85.0%	715	894	1,072	1,251	1,430	

Data Points to Compare to Any Illustrative Mark-to-Market Analysis

Summary of Recent Findings (1/2)



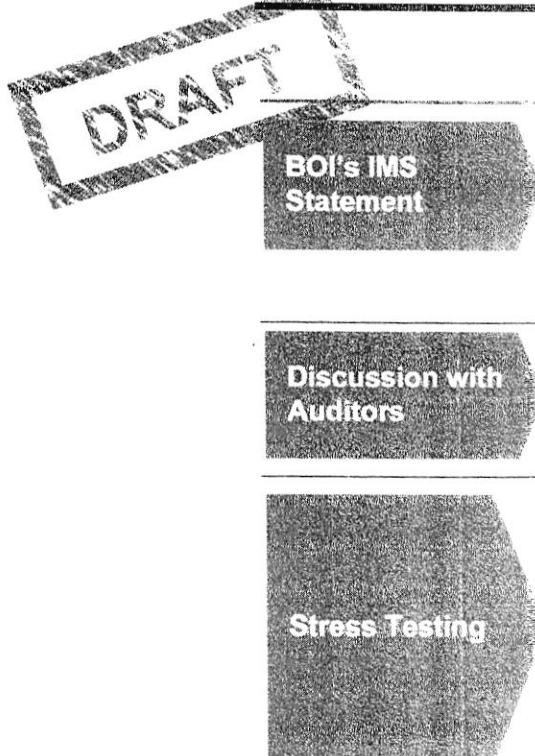
Data Points

- "The European Commercial book which is approximately €1bn. () would not envisage any loss on this book and in fact would expect to generate significant fee income from this book on an ongoing basis."
- "The UK commercial book comprising €5.3bn of which €3.5bn is development (residential related). () rarely get involved in construction. Practically all are well located and well diversified in the London area. This is a very robust and good quality book where the borrowers are extremely strong successful and professional"
 - By continuing to work pro-actively with the borrowers () believe there would be no substantial losses in the portfolio. () also expect to generate strong fee income on an ongoing basis from this book as it matures
- The Society's home loan/R.I.P. book of approximately €2.5bn is substantially a seasoned book with relatively low average LTV's. () expect relatively modest losses on this book, considerably less than 1%
- The Irish commercial book totalling €2.9bn of which approximately €2bn is development related. The Society has identified a small number of transactions that could result in losses but the body of the book is sound. () also expect some modest fee income from the book
- Overall we would envisage a realistic provision in our accounts this year of between €60 and €100m and a declared pre-tax profit of €150/175m
- Therefore, to summarize: the Society as a going concern is a very profitable financial institution. Its mortgage book cannot be judged on a "fire sale basis" which formed the basis of our discussion last night

- Nature of loans are very bespoke and specific
- An assessment of the loans requires a detailed understanding of the underlying project
 - Understanding the nature of the project will maximise understanding of the possible impairment and the maximum recovery level
- Management have a high degree of confidence in the quality and expected performance of the loans
- Management have sought to see cross charges, guarantees and second liens to bolster the security of the loan book
- Management appear to hold a significant amount of knowledge regarding the status of borrowers and repayment probability

Data Points to Compare to Any Illustrative Mark-to-Market Analysis

Summary of Recent Findings (2/2)



Summary Illustrative Mark-to-Market Analysis of Total Loan Book

Highly Preliminary

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	BS Value at 31 Aug 2008 (€m)	Best Mark	Worst Mark	High Value	Low Value
Commercial Loan Book	9,364	67.7%	33.9%	6,336	3,175
Residential Loan Book	2,390	74.9%	64.9%	1,791	1,552
Total Loan Book	11,754	69.1%	40.2%	8,127	4,727

- Combining the commercial real estate and residential loan book mark to market exercises results in a highly preliminary loan book valuation range of €4.7bn - €8.1bn
 - This corresponds to 40% - 69% of the loan book carrying value of €11,754 as at 31 August 2008
- This assumes that the commercial real estate marks of 34% - 68% for the top 30 exposures apply to the entire €9.4bn commercial loan book
- In order to refine this analysis full loan-by-loan detail would be required for each portfolio

A mark-to-market analysis applied to most other banks' loan books in the current credit/liquidity environment would yield significant mark-downs

Illustrative Mark-to-Market of Commercial Book (1/3)

Overview

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We have performed a highly preliminary analysis to estimate the potential mark-to-market valuation of the commercial loan book

- This analysis uses the market yield on actively traded CMBS as a reference rate for the yield a purchaser would expect to achieve on acquiring Harmony's loan book
- For example, if Harmony's loan book had a weighted average margin of 2% and CMBS of a similar quality were trading with a spread of 3%, a purchaser would adjust the par value of the loans yielding 2% until they yielded 3%
- The corresponding reduction in loan book value is equivalent to the NPV of the interest rate differential between the yield on the book and the CMBS yield (in this case $3\% - 2\% = 1\%$) over the average duration of the book
- Key assumptions include:
 - Loans to the Top 30 exposures are representative of the entire €9.4bn book (e.g. LTVs, margins, duration)
 - US CMBS are an appropriate proxy for the market yield of European CMBS given there is no European CMBS index
 - A discount rate of 15% is appropriate to discount the interest rate differential over the life of the loans
 - Assumptions regarding the proportion of Harmony's book that would generate AAA, AA, A and BBB rated securities are appropriate

This analysis applied to the Commercial loan exposures of most banking books (for many financial institutions) would yield a significant mark-down in the current credit environment

Illustrative Mark-to-Market of Commercial Book (2/3)

Top 30 Exposures – Not Entire Loan Book (circa. 50%)

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Methodology

- Step 1 involves reducing collateral values based on the year the last third party valuation was performed using similar haircuts to those applied in the financing analysis. As at 31 August 2008 collateral value per the top 30 loan template was EUR 5,861m – this has been haircut by 28% to EUR 4,205m
- So the loan book can be compared to traded CMBS securities, the book is tranches in a similar way to if it were being prepared for securitisation. The key driver of this tranching is the LTV required for loans to achieve a credit rating of AAA, AA, A, BBB or to be classed as mezzanine
- The yield on the loans allocated to each tranche is then compared to the yield on similar tranches of traded CMBS securities to calculate the margin differential. The present value of this margin differential over the life of the loan is then used to calculate mark-to-market of the loan book

2 - Tranching of Loan Book

Credit Rating	Required LTV		Total Loan Book	Implied Quantum of Loans in Tranche (€m)	
	Min	Max		Min	Max
AAA	10%	30%	4,205	420	1,261
AA	20%	40%	4,205	420	420
A	30%	50%	4,205	420	420
BBB	40%	60%	4,205	420	420
Mezzanine / Equity				3,440	2,599
Total			4,205	5,121	5,121

1 - Stressed Collateral Value Calculation

Data as of 31-Aug-2008	
Top 30 Exposures	5,121
Original LTV	87.4%
Collateral Value	5,861
Stressed Collateral Value¹	4,205
Implied Stressed LTV ¹	121.8%

3 - Required Margin Calculation

Credit Rating	Implied Quantum of Loans in Tranche (€m)		Required CMBS Spread	Weighted Spread		
	Min	Max		Min	Max	Worst
AAA	420	1,261	2.15%	2.50%	0.18%	0.62%
AA	420	420	9.10%	9.50%	0.75%	0.78%
A	420	420	13.15%	14.00%	1.08%	1.15%
BBB	420	420	25.35%	26.00%	2.08%	2.13%
Mezzanine	3,440	2,599	29.00%	30.00%	19.48%	15.22%
Total	5,121	5,121			23.56%	19.90%

¹ See adjustments made to original LTV depending on year of 3rd party valuation in financing section.

Illustrative Mark-to-Market of Commercial Book (3/3)

Top 30 Exposures – Not Entire Loan Book (circa. 50%)

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	Margin Differential	
	Worst	Best
Current Margin	1.94%	1.94%
Required Margin	23.56%	19.90%
Flex	1.00%	1.00%
New Margin + Flex	24.56%	20.90%
Margin Differential w/ Flex	22.62%	18.97%

- Based on a highly preliminary mark-to-market analysis based on observable market prices for CMBS, the valuation range for the top 30 exposures is in the region of €1.7bn – €3.5bn or 34 - 68% of the loan book carrying value
- At these valuations the loan book yield would be comparable to spreads on traded CMBS securities of a similar quality

Loan Book Mark if Weighted Duration is 2 Years and Margin Differential is Best

WA Life of the Loans	2
Margin Differential w/ Flex	18.97%
Year 1 Year 2 Year 3 Year 4 Year 5	
Annual Margin Differential	971
NPV of Margin Differential	1,579
Discount Rate	15%
Fees	1.50%
Value of Loans	3,466
Mark-to-Market of Loan Book as % Par Value	67.7%

Loan Book Mark if Weighted Duration is 4 Years and Margin Differential is Worst

WA Life of the Loans	4
Margin Differential w/ Flex	22.62%
Year 1 Year 2 Year 3 Year 4 Year 5	
Annual Margin Differential	1,159
NPV of Margin Differential	3,308
Discount Rate	15%
Fees	1.50%
Value of Loans	1,737
Mark-to-Market of Loan Book as % Par Value	33.9%

Illustrative Mark-to-Market of Residential Book

Overview and Indicative Analysts



Methodology

- In the current market environment a purchaser is likely to mark the residential loan book to market
- The first step in this process is to allocate the loans to LTV bands
- The loan balance in higher LTV bands will likely be marked down more than loans in lower LTV bands given lower levels of collateral support
- The below table represents GS Mortgage Desk's highly preliminary estimate of the marks that could be applied to loans in each LTV band
- The analysis indicates the mark-to-market value of the €2.4bn residential loan book could be between €1.5bn to a.€1.8bn, or 65%-75% of par value

Illustrative Calculations

Indexed Bands	Loan Value (€m)	%	Marks Range			Marked Loan Book		
			Min	Med	Max	Min	Med	Max
>95%	367	15%	45%	50%	55%	165	183	202
>90%	92	4%	50%	55%	60%	46	51	55
>80%	302	13%	55%	60%	65%	166	181	196
>70%	302	13%	60%	65%	70%	181	196	211
>60%	318	13%	65%	70%	75%	206	222	238
>50%	240	10%	65%	70%	75%	156	168	180
>25%	459	19%	80%	85%	90%	367	390	413
<25%	310	13%	85%	90%	95%	264	279	295
Total	2,390	100%				1,552	1,671	1,791
						As % of Par Value	64.9%	69.9%
							74.9%	

Similar levels of mark could be expected across a wide range of institutions with mortgage books of this nature

Financing Package Parameters (1/5)

Funding

DRAFT

Considerations	
Quantum	<ul style="list-style-type: none"> ■ As a base scenario, funding may be required to <ul style="list-style-type: none"> — Replace MTN funding as it falls due — Replace IoM and corporate deposits at maturity — Replace a significant quantum of retail deposits over time ■ To avoid a deposit run, loan will need to rank behind deposit claims
Seniority	<ul style="list-style-type: none"> ■ New MTN funding is unlikely to be available, regardless of ranking ■ State has the ability to precede MTN claims, though will lead to receivership
Security/ Collateral	<ul style="list-style-type: none"> ■ Subject to regulatory restrictions, loan could be secured on all available collateral (similar to NR)
Cost of Funds	<ul style="list-style-type: none"> ■ Commercial benchmarking will be difficult, other than in a presumed pre-support scenario ■ Subsidy will be differential of assumed commercial rate and actual coupon, though may be non-cash pay structure <ul style="list-style-type: none"> — Subsidy could also be repaid through profit participation as equity/warrant/preferred participation
Guarantee	<ul style="list-style-type: none"> ■ Provision of guarantee may reduce funds required, though economic cost and risk is similar ■ Rating agencies may sell guarantees to avoid further downgrades (TBD) ■ In any sale of all or part, the provision of a guarantee or 'risk shield' (KfW support for IKB) may be required

Financing Package Parameters (2/5)

Capital

DRAFT	
Regulatory Capital	<p>Considerations</p> <ul style="list-style-type: none"> ■ Initial view suggests capital impact may be manageable <i>~ Scenario where market has to stand alone with</i> ■ Potential scaling down of activities may also reduce capital requirements ■ Given high quality of core tier 1 capital and potential for profit participation, a smaller proportion of State support could be structured as subordinated debt/preference share to bolster capital position ■ Any capital waivers in the future should be factored into any support package ■ Subsequent capital support may be politically sensitive (see NR capital requirement of up to £3bn by UK government in August)
Profit Participation	<ul style="list-style-type: none"> ■ Multiple structures could be utilised ■ Equity share/warrants (AIG) ■ Preferred capital (Fannie, Freddie) ■ Residual interest on sale (NR) ■ Profit 'sweep', fixed return, pro rata share (private bidder proposals in NR)

Financing Package Parameters (3/5)

Governance

DRAFT

Governance is a complex balance of what is seen to be appropriate and what works commercially and should be considered in light of quantum of support and ongoing commercial strategy	
Considerations	
Board	<ul style="list-style-type: none"> ■ With any support package, some level of board appointment is appropriate <ul style="list-style-type: none"> — Exact representation may depend on requisite appearance of Harmony to public and markets — Consider direct State representatives and new private sector appointees — Important to note power/representation also has revenue implications on the State, important where unpopular decisions need to be made (NR reposessions) — Independence may be important if standalone structure adopted
Executive	<ul style="list-style-type: none"> ■ Seek balance between maintaining and attracting the best commercial executives and providing for controls and succession ■ Given the complexity of the commercial assets, it will be critical to maintain relationships with creditors / developers through an established and motivated management team, with appropriate controls ■ Change of key lending executives is likely to impact adversely relationships with developers and ultimate recoveries ■ Important that any new appointments are credible and will provide stability
Supervision	<ul style="list-style-type: none"> ■ Primarily a regulatory matter, though expected to be tightened significantly ■ Option could include appointment of regulatory observer ■ Need to separate commercial and regulatory control

Financing Package Parameters (4/5)

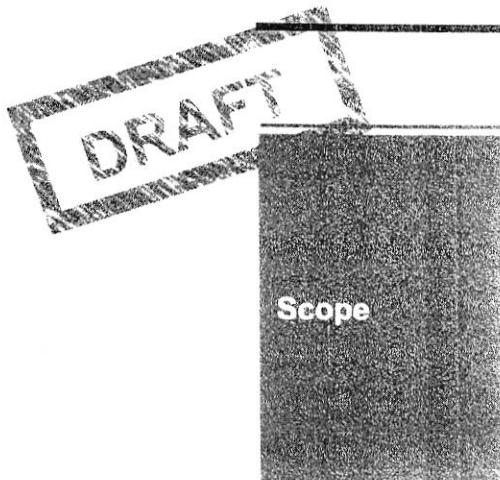
Ownership

DRAFT

	Considerations
Government	<ul style="list-style-type: none"> ■ State ownership should be determined by balance of compensation for support ('moral hazard') and the need for control and strategy to achieve best recovery/lowest risk ■ Ability to separate ownership (profit participation) from control <ul style="list-style-type: none"> — Given other State objectives, ownership may also be seen as a two-way responsibility when difficult decisions are made ■ Important to consider which State entities would provide funds and be responsible for ownership interests
Members	<ul style="list-style-type: none"> ■ Depending on the chosen structure, maintaining a participation by members may improve deposit retention ■ Structures may vary <ul style="list-style-type: none"> — Appropriateness of break-up or sale — Potential for continued actual participation or contingent payment — Representations of future value or windfall must be balanced
Management	<ul style="list-style-type: none"> ■ Post-support management team should be appropriately incentivised

Financing Package Parameters (5/5)

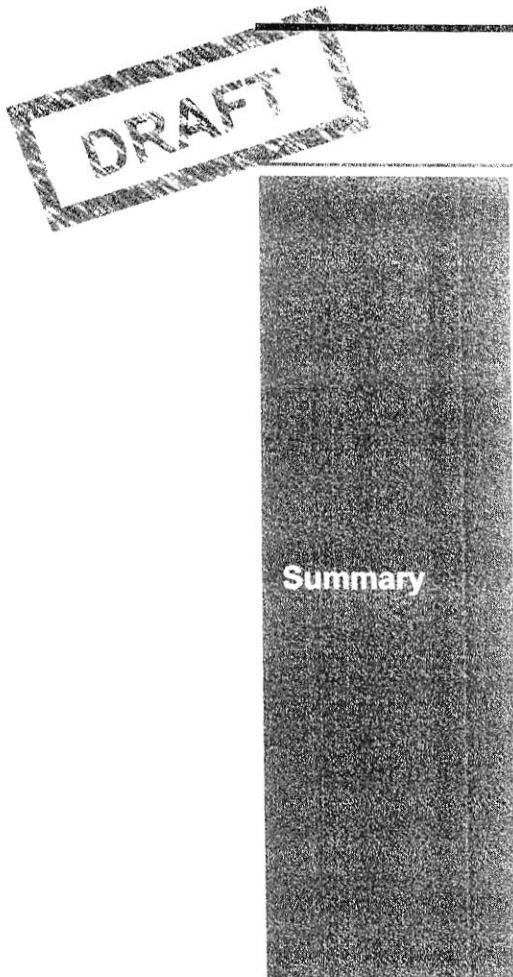
Business



Considerations

- Depending on structure chosen, the scope of the business should be addressed
 - Break-up option determines this at outset
 - In standalone or nationalised structures, the scope of the business should be assessed in the light of realistic, not aspirational, long term goals
- In particular, where deposit taking activities receive State support, the consequences for other market participants should be considered

Overview of Potential Structural Alternatives (1/2)



"Northern Rock" UK Structure

- Nationalise equity and take into public ownership
- Maintain as going concern with aspiration to sell or IPO
- Provide long-term guarantee to all creditors (except subordinated debt)
- Maintain and attract deposits
- Fund all other liabilities immediately
- "Independent" board within government ownership
- Significant State Aid implications

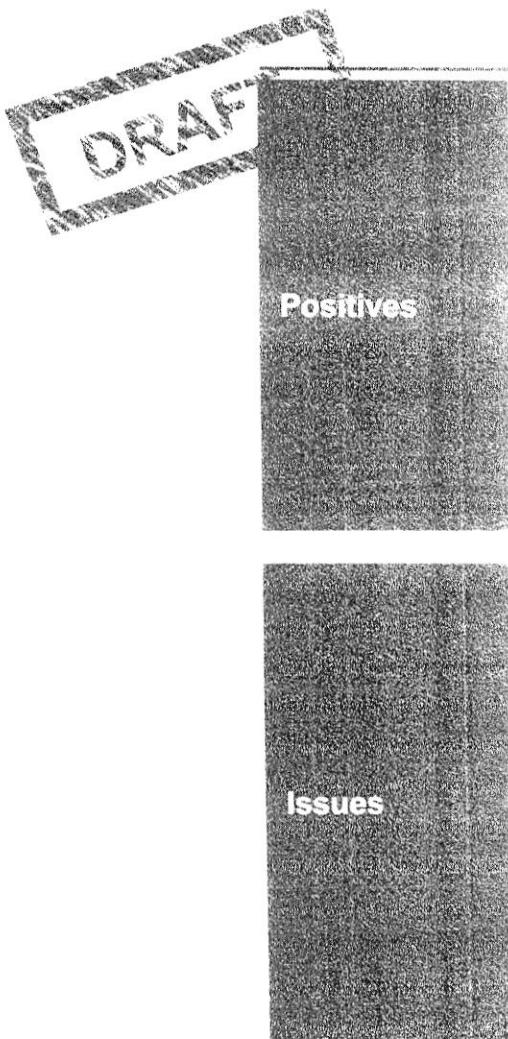
Standalone

- Take preferred equity or partial equity position
- Maintain some going concern element within restrictions (existing business strategy has effectively ceased any commercial loans)
- Fund or guarantee all or part liabilities
- Clarify medium-term business plan objectives
- Significant State influence (board, executive appointments)
- State Aid issues may be addressed through issue of equity participation to the State

Break-up

- Transfer deposits, branches, residential assets and cash to a third party bank
- Hold commercial property assets in new vehicle, funded by State
- MTNs to be transferred by legislation or repaid
- Determine relevant management team(s) to work out CP assets
- Minimises State Aid through compensatory measure of closing down CP business

Overview of Potential Structural Alternatives (2/2)



'Northern Rock' UK Structure

Standalone

Break-up

<ul style="list-style-type: none"> Decisive action may reduce contagion risk Maximises stability very quickly Sends very strong signal of support to market Provides time to take longer term decisions on strategy 	<ul style="list-style-type: none"> Least 'intrusive' form of support Facilitates 'business as usual' response May have least impact on depositor and creditor behaviour Lowest initial funding need; avoid deposit guarantee 	<ul style="list-style-type: none"> Decisive action on deposits and branches may maintain value Potential positive impact on acquiror Residential assets effectively sold
<ul style="list-style-type: none"> Maximises State exposure, though may reduce immediate funding needed and attract deposits May attract deposits from other institutions Ultimate exit questionable Impact of nationalisation on depositors and reaction of creditors/willingness to pay 	<ul style="list-style-type: none"> May ultimately be only an interim step – risk of slow slide towards further funding support Subtleties of business restrictions, board influence, equity sharing may be lost in public perception 	<ul style="list-style-type: none"> Funding requirements will be significant Branch acquiror may seek support to refinance residential assets CP creditor behaviour State retains CP risk – mitigated by 3rd party management

From: Beausang, William
Sent: 08 May 2008 09:35
To: Manley, Michael
Cc: Lonergan, Ciara; Nolan, Kevin
Subject: Version submitted to KC - no changes other than key points added

Attachments: revised Briefing for Minister for Finance May 2008 rev1 (2).doc



revised Briefing for
Minister ...

Briefing on 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.

The key points are as follows:-

International Position

- Since last August, as a result of the “credit crunch” normal wholesale inter-bank lending and funding activities (e.g. securitisation) have at an international level seized up; in essence bank funding is either much more expensive or unavailable at the longer-term maturities that banks need
- While there have been some recent assessments suggesting the environment is set to improve, there are no clear indications that current difficulties will ease significantly for some time.
- Any further marked deterioration in economic conditions in the US or the EU will lead to a worsening of credit conditions.
- An extensive programme of actions is being put in place at EU level to improve financial market conditions and prepare for any risk to financial stability in the EU.
- International central banks, the US Federal Reserve and the ECB / Eurosystem have been very active in seeking to stabilise market conditions.

Situation in Ireland

- The Irish banking system is sound and robust based on all key indicators of financial health (i.e. solvency, liquidity, asset quality, profitability)
- Irish banks have no meaningful exposure to the sub-prime securities which are at the root of the international liquidity crisis overall.
- International sentiment towards the Irish banks is very negative on account of the assessment that the pronounced downturn in the Irish market will undermine their financial position.
- Irish banks are therefore experiencing significant challenges in rolling-over their funding sources.
- In addition there has been intense speculation by hedge funds against specific Irish banks (i.e. Anglo-Irish and Irish Life and Permanent) which on occasion

has put very serious downward pressure on their share price which has increased the risk of a run on deposits on those banks.

- Irish banks have been working intensively to exploit any funding opportunities available internationally; as relatively small financial institutions by international standards they have not extensive options
- The Irish banks have built up large reserves of assets that are eligible to be used as collateral against lending by the ECB in circumstances that other funding sources are not available.
- In general, Irish banks are reluctant to access this funding owing to the risk that this will send a negative signal to the market and lead to the shutting down of other credit lines.
- A domestic shock (e.g. failure of a major property developer or very sharp further falls in property prices) would have a major negative effect on the financial position of the Irish banks on a systemic basis.

Contingency Planning

- The Financial Regulator and the Central Bank have been working very closely with the banks to monitor their liquidity position on an ongoing basis and seek to identify risks to their sustainability at the earliest possible stage.
- The Department of Finance, Central Bank and Financial Regulator are in very close contact to exchange information on developments and advance contingency planning arrangements for dealing with the emergence of serious difficulties in any specific institutions or the banking system as a whole.

Primacy of market solutions

- Responsibility for managing current issues affecting individual institutions and developing strategic options for responding to the market environment rests with the boards and senior managers of the institutions concerned.
- The CEO of the FR has been meeting with the boards / top management of some financial institutions to impress upon them the need to be prepared to examine all options to pre-empt the emergence of any difficulties.
- State intervention is only appropriate in circumstances that problems in an individual institution run the risk of creating systemic difficulties in the national financial system as a whole.

Detailed information note attached.

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.

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 weak¹, which had caused it to announce a special scheme to

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

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.

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.

property sector, and financing difficulties could emerge in some emerging markets, including countries in Central and Eastern Europe with large current account deficits

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

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 statutory² 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).

²Central 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) \$1 billion. 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 from 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.

Informal Ecofin 7-8 April 2006.

Financial Market Stability

Suggested Speaking Points:(*if required*)

Supervisory Convergence & Stability, and Crisis Management

Housing

- I am aware that rising house prices in Ireland have been highlighted as a potential source of instability, due to the possible over-exposure of banks in this sector.
- This issue is being addressed. Last Friday the Irish Financial Regulator increased the risk weighting of certain types of residential mortgages, thus requiring banks to set aside a higher level of capital for loans which exceed 80% of the value of the property.
- The factors driving Irish house prices are structural rather than speculative. These include:
 - Strong economic growth
 - A rapid increase in population, primarily fuelled by high immigration
 - High employment levels and income increases
 - Low interest rates

- I might mention that in the 1970's, one third of all household income was used to service mortgage repayments. Today, even with the high housing costs, this ratio remains at a similar level.

Other issues (if appropriate)

- I would now like to address some of the other issues that have been raised.

Possible – Conglomerates – co-operation between supervisors

- We welcome the Memorandum of Understanding signed by the three Regulators' Committees in November as being a constructive approach to dealing with cross-sectoral issues, particularly with respect to financial conglomerates

Possible – Single European Regulator for Financial Services

- We are opposed to the idea of a Single European Regulator.
- We don't see any evidence of a need to go down this road and indeed it wasn't even highlighted as an issue in the Commission's recent 2005-2010 White Paper.
- All existing legislation is predicated on each Member State having its own competent authority.

- Most recent legislation, such as the Markets in Financial Instrument Directive, is based on appropriate exchange of information between competent authorities.
- We would be concerned if efforts to create a shared database for such exchanges of information, were to be used as an excuse for creating a pan-European Regulator.

Possible - Hedge funds.

- I recognise the importance that hedge funds play in the current market-place. The risk diversification they provide is important.
- In Ireland, hedge funds are restricted to high net worth investors, although retail investors are permitted to invest in “funds of hedge funds”
- I welcome the calls for an enhancement of measures to ensure market integrity by monitoring the activities of large hedge funds and their counterparties.

Informal Ecofin 7-8 April 2006.

Financial Market Stability

Steering Note

Supervisory Convergence & Stability, and Crisis Management

What will happen today?

The Chair of the EFC will provide Ministers with an oral report on the current state of play. This oral report will be based on the EFC's examination of the Financial Services Committee (FSC) paper of 23rd February 2006. The paper is not being circulated to Ministers.

The main points are expected to be:

- The need for swift implementation of the measures set down in the FSC paper.
- Issue an invitation to the FSC to look at the Commission's 5 year plan (2005-2010) and to set down priorities.
- Call on Member States to ensure Directives are transposed in a timely fashion
- Call for the 3 sectoral regulators (i.e. Lamfalussy Level 3 Committees) to work more closely together in the area of financial conglomerates.

A short update on the crisis management exercise on 6 April is also expected – this will be discussed in more depth at a later Ecofin.

Irish position

The FSC report received wide support. Ireland expressed concerns about the level of detail and suggested that a more concise version be produced. This, presumably, is one of the reasons why a written copy of the report is not being circulated to Ministers at this stage. We have no particular difficulties with regard to the supervisory convergence issues raised, although some of the measures seem a bit premature to us.

However, there was a comment at the EFC regarding the dangers to financial stability posed by the Irish and Spanish housing markets and a draft speaking note is included if an intervention is thought necessary.

There were also some comments at the EFC regarding co-operation between regulators regarding financial conglomerates, the possibility of a single European financial services regulator and on the need to monitor hedge funds more closely. Short speaking notes are provided if required.

Informal Ecofin 7-8 April 2006.

Financial Market Stability

Background Note

Supervisory Convergence & Stability and Crisis Management

Background Note

This issue has been around for some time. It stems, principally, from complaints by major financial institutions about the divergent implementation in Member States of the measures contained in the Financial Services Action Plan. Such divergences were thought to be harmful to a true internal market. Some Member States were also concerned at the lack of consistency across the EU and called for greater harmonisation.

This issue has already been discussed at Ecofin on 7 December 2004. Those Ecofin conclusions invited the FSC to provide a strategic overview of how the existing framework for financial regulation and supervision should be developed over the next few years. The FSC report to the EFC, dated 23 February 2006, is its formal response to the Ecofin invitation.

Some issues arising.

Crisis Management Exercise – 6 April 2006.

The EFC Financial Crisis Management (FCM) exercise was based on an EU which consists of 5 hypothetical countries. The same exercise was run 3 times simultaneously on 6 April and participants from Member States were divided into 3 teams. Participants were allocated roles which represented their roles in Finance Ministries, Central Banks, or as Banking Supervisors of one of the hypothetical States.

Supervision of Financial Conglomerates

In paragraph 18 of the revised EFC paper of 31 March, a call is made for an “urgent establishment the level 3 co-operation on conglomerates between supervisors”. While such co-operation is indeed important, the paper does not take note of the fact that, last November, the 3 Committees did in fact sign an MOU specifically for this purpose. A short reference to this point is included in the Speaking Note, if required.

Single European Regulator

This issue was raised at last week’s EFC. We, like many other MS see no justification for a single regulator. A short speaking note is provided, in case the matter is raised at Ecofin.

Hedge Funds

Financial Stability concerns were raised in relation to hedge funds, particularly in respect of banks’ exposures. The paper calls for closer monitoring of such funds. We agree with this and a short speaking note is provided, if required.

Informal Ecofin 7-8 April 2006.

Financial Market Stability

Press Points

Supervisory Convergence & Stability, and Crisis Management

- The President of the Economic and Financial Committee (EFC) gave an oral presentation to Ministers on progress being made with regard to cross-sector supervision in the area of financial services.
- The Financial Services Committee was invited by Ecofin in December 2004 to examine this issue and their report forms the basis for today's presentation.
- The EFC's presentation noted that stability in the banking, insurance and securities sectors remain solid.
- The EFC highlighted the need to enhance measures to ensure market integrity and stability in the area of hedge funds.

Informal Ecofin 7-8 April 2006.

Financial Market Stability

Composite Introductory Note

Supervisory Convergence & Stability, and Crisis Management

The Chair of the EFC will provide Ministers with an oral report on the current state of play. This oral report will be based on the EFC's examination of the Financial Services Committee (FSC) paper of 23rd February 2006. The paper is not being circulated to Ministers.

Irish Position

We have no particular difficulties with regard to the supervisory convergence issues raised, although some of the measures seem a bit premature to us.

However, there was a comment at the EFC regarding the dangers to financial stability posed by the Irish and Spanish housing markets and a draft speaking note is included if an intervention is thought necessary.



Presentation to
Irish Ministry of Finance
Regarding
**Summary Considerations For Re-Capitalising Irish
Financial Institutions**
November 10, 2008



Global Markets & Investment Banking Group

29/Aw/331

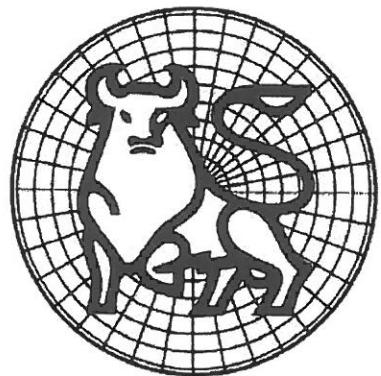
Summary Considerations For Re-Capitalising Irish Financial Institutions

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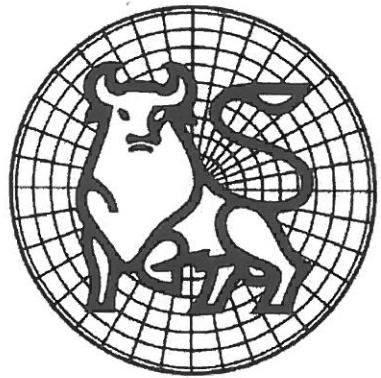
Introduction

Introduction

Introduction

- Further to our previous discussions with respect to re-capitalising the Irish financial institutions, we understand that the Irish Government is considering a specific instrument that is perpetual with a call date between 5 and 7 years and with a principal redemption guarantee from the government
 - We have laid out what we believe to be the key considerations and cost of this option in the following pages (see page 2)
- After due consideration, our primary conclusion is that the Department of Finance should not pursue this structure any further for the following reasons (discussed in greater detail on page 3):
 - Significant risks exist that the current proposal will be characterised as State aid
 - The proposed structure does not offer material 'value' versus recent structures issued in the market or existing instruments
 - The new and 'complicated' nature of the proposed instrument makes it unclear who the natural buyer base of any such product would be, i.e. debt or equity buyers, institutional or retail buyers, credit or supra/sovereign investors
 - It is still likely that the Irish Government will have to subscribe for a large proportion of the instruments
 - Any participation from third party investors (i.e. traditional rates buyers / guaranteed product buyers) is likely to cannibalise future demand and pricing for Irish Government issues
 - The proposed structure presents substantial dilution risk to the participating institutions should they be unable to re-finance the preference shares through the issue of ordinary shares
 - Institutions will be concerned about the overall redemption risk i.e. the inability for the institutions to refinance the instruments through cash or ordinary shares
- However, we present 3 alternatives for the Irish Banks to achieve Core Tier 1 or Tier 1 capital based on recent precedents (see page 5)
 - We currently believe that a Preference Shares + Warrants structure still best satisfies the core objective of a simple product that adequately capitalises the institutions whilst maximising protection to the State
- Finally we provide a summary of instruments used by other Governments (see Appendix 1)





Key Considerations For Irish Ministry Of Finance

Key Considerations For Irish Ministry Of Finance

Considerations With Respect To Proposed 'Guarantee' Prefs

	Feature	Key Considerations
Maturity	<ul style="list-style-type: none"> ■ A perpetual instrument with a call date between 5 and 7 years 	<ul style="list-style-type: none"> ■ As per Irish bank regulations regarding capital instruments, any Tier 1 eligible security must be perpetual. An alternative could be to issue a mandatory convertible security with a conversion period at a specified date
Coupon	<ul style="list-style-type: none"> ■ A varying coupon depending on the institution for which the Preference Shares are being subscribed ■ The coupon will range from 8% for larger banks to 12% for other banks (including Anglo Irish) 	<ul style="list-style-type: none"> ■ Coupon should be set at levels comparable to market terms and/or comparable to those of recent capitalizations depending on the nature of the investor ■ Warrants over ordinary shares would reduce the upfront coupon
Redemption	<ul style="list-style-type: none"> ■ Banks would be free to redeem the Preference Shares at any time out of the issue of new ordinary shares ■ If the Preference Shares were not redeemed by the call date, the Irish State has the right of conversion into ordinary shares at a 50% discount to the prevailing market price 	<ul style="list-style-type: none"> ■ Providing the ability for the banks to redeem at any time, coupled with the downside risks being faced by the government, skews the economics in favour of the banks and could result in a significant transfer of value
Clawback	<ul style="list-style-type: none"> ■ Existing investors would have the first right to acquire the instruments ■ To the extent that the instrument is not fully subscribed, residuals would be made available to general public, with the aim that State would put in a minimal amount 	<ul style="list-style-type: none"> ■ We do not envisage a large subscription for the instrument from third party investors (we provide further detail for this on the following page)
State Guarantee	<ul style="list-style-type: none"> ■ State to a guarantee gross redemption yield at, say, 2.5% 	<ul style="list-style-type: none"> ■ As per Basle principles regarding capital instruments, these should have no credit enhancements ■ No other EU member state incorporated a state guarantee on Tier 1 eligible instruments ■ Significant risk of characterization as state aid



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Key Considerations For Irish Ministry Of Finance

Key Draw Backs With Current Proposed Structure

Key Draw Backs With Current Proposed Structure

- No other EU member states have incorporated a guarantee feature on Tier 1 eligible instruments
 - The Irish Government's current guarantee already encompasses the widest range of instruments seen vis-à-vis other European Government interventions and so could draw criticism from the E.U.
 - Significant risks exist that the current proposal will be characterised as State aid
 - Pricing of other non principal guaranteed Tier 1 instruments will be negatively impacted
- The current proposed structure currently does not offer material 'value' versus precedent structures in the market or existing instruments
 - It is unlikely that weaker banks (i.e. Anglo, IL&P, Irish Nationwide) are likely to receive any external sponsorship from market participants
 - For strong banks (i.e. AIB, Bank of Ireland) we also expect third party investor participation to be limited
- It is still likely that the Irish Government will have to subscribe for a large proportion of the instruments
 - The nature of the new instrument as 'guaranteed' preference shares makes it unclear who the natural buyer base of any such product would be, i.e. debt or equity buyers, institutional or retail buyers
- Any participation from third party investors (i.e. traditional rates buyers / guaranteed product buyers) is likely to cannibalise future demand for Irish Government issues
 - Government / Sovereign / Supra investors will potentially be attracted to deals if priced close to a yield of Irish Gilt debt
 - Institutional credit buyers are yield driven and so will dramatically under perform indices if paid a yield of 2.5%
 - Any retail participation will be minimal in our view \leq €500m
- The proposed structure presents substantial dilution risk to the participating institutions should they be unable to re-finance the preference shares through the issue of ordinary shares. Institutions will be concerned about the overall redemption risk i.e. the inability for the institutions to refinance the instruments through cash or ordinary shares
- We present on the following pages our views on how the proposed structure can be amended to create a more 'workable' solution as well as a summary of alternative instruments that have been used in European Government sponsored recapitalisations

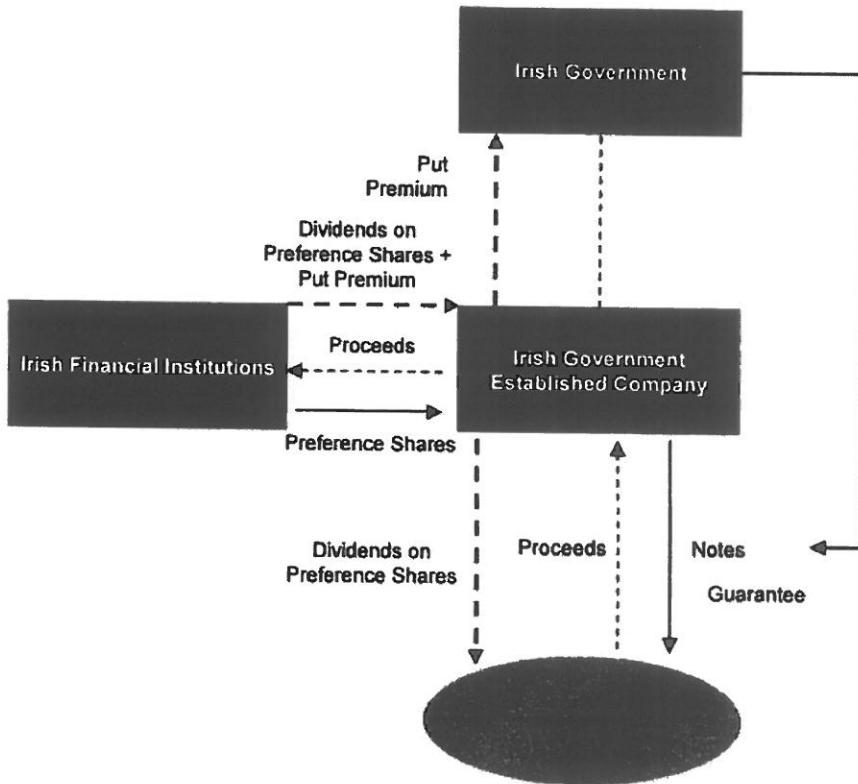


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Key Considerations For Irish Ministry Of Finance

Considerations With Respect To Proposed 'Guarantee' Prefs (Con't...)

Proposed Alternative Structure



Mandatory Convertible Preference Shares

Type of Securities	<ul style="list-style-type: none"> Mandatory Convertible Preference Shares
Size	<ul style="list-style-type: none"> Dependent upon each institutions required level of recapitalisation
Maturity	<ul style="list-style-type: none"> 5 years
Distributions on Preference Shares	<ul style="list-style-type: none"> Banks will make distributions at their discretion on the following terms (put premium is not discretionary): <ul style="list-style-type: none"> Stronger Banks: 8% Dividend Yield + c.4% Put Premium (to Government) Weaker Banks: 12% Dividend Yield + c.4-5% Put Premium (to Government)
Conversion Features	<ul style="list-style-type: none"> Can be redeemed at any time with proceeds obtained through the issuance of capital of at least similar quality at a premium of [125)% Automatic conversion into ordinary shares on yr 5 Strike Price: 50% of the share price at the issue date
Additional Characteristics Information	<ul style="list-style-type: none"> Voting rights – None Transferability - Yes Corporate governance restrictions (these exist only as long as Irish state remains as investor): <ul style="list-style-type: none"> Limits on executive remuneration Ability to introduce non-executive directors into company Usual dividend stopper on junior instruments (i.e. ordinary) should no distribution be made on the preference shares
Investor	<ul style="list-style-type: none"> Aim to reduce Government participation as much as possible with third party placement Security is transferable providing the Government with the ability to monetise / exit its investment in the future

Government Notes

Type of Securities	<ul style="list-style-type: none"> Government guaranteed notes linked to dividend yield on preference shares
Issuer	<ul style="list-style-type: none"> An Irish entity set up as an Irish incorporated company owned by the Irish Government, eligible for Irish taxation purposes under Section 110
Size	<ul style="list-style-type: none"> Dependent upon each institutions required level of recapitalisation
Maturity	<ul style="list-style-type: none"> 5 years
Distributions	<ul style="list-style-type: none"> Greater of 2.5% and (i) 8% and (ii) 12% depending if bank makes distributions on the Mandatory Convertible Preference Shares



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Key Considerations For Irish Ministry Of Finance

Summary Of Alternative Recapitalisation Instruments

	Preference Shares + Warrants	5 Year Mandatory Convertible Securities (Swedbank Style Structure)	Callable Preferred Convertible Securities (KBC Style Structure)
Type of Securities	<ul style="list-style-type: none"> Preference Shares + Warrants 	<ul style="list-style-type: none"> Mandatory Convertible Preference Shares 	<ul style="list-style-type: none"> Preferred Convertible
Size	<ul style="list-style-type: none"> Dependent upon each institutions required level of recapitalisation 	<ul style="list-style-type: none"> Dependent upon each institutions required level of recapitalisation 	<ul style="list-style-type: none"> Dependent upon each institutions required level of recapitalisation
Maturity	<ul style="list-style-type: none"> Perpetual; callable at 5 years Bank can repurchase at any time at a predetermined premium, subject to replacement of capital and IFSRA approval 	<ul style="list-style-type: none"> 5 years A 3 year maturity may be requested by the respective institutions in order to maximise rating agency credit (ATE high from S&P) 	<ul style="list-style-type: none"> Perpetual; callable at any time at a 150% premium
Distributions	<ul style="list-style-type: none"> 12% for the stronger banks 16% for the weaker banks 	<ul style="list-style-type: none"> 8% for the stronger banks 12% for the weaker banks 	<ul style="list-style-type: none"> 9% for the stronger banks 13% for the weaker banks Dividend greater of stated coupon or a multiple of dividends on common as follows: 105% for 2008, 110% for 2009 and 115% thereafter
Conversion Features	<ul style="list-style-type: none"> No. of Warrants: Issue size divided by strike price Warrant Maturity: 5 years Strike Price: 100% of the share price at the issue date 	<ul style="list-style-type: none"> Strike Price: 70% of the share price at the issue date Conversion: Automatic in year 5 No. of underlying shares: Issue size divided by the strike price 	<ul style="list-style-type: none"> Issuer Forced Conversion: From year 3 (Govt can opt to receive 100% of issue price in cash instead of shares) Conversion Price: 100% of share price at issue date No. of Underlying Shares: Issue size divided by strike price
Additional Characteristics/ Information	<ul style="list-style-type: none"> Voting rights - None Transferability - Yes Corporate governance restrictions: <ul style="list-style-type: none"> Limits on executive remuneration Ability for State to introduce non-executive directors into company Dividend stopper on instrument 	<ul style="list-style-type: none"> Voting rights - None Transferability - Yes Corporate governance restrictions: <ul style="list-style-type: none"> Limits on executive remuneration Ability for State to introduce non-executive directors into company Dividend stopper on instrument 	<ul style="list-style-type: none"> Voting rights - None Transferability - Yes Corporate governance restrictions: <ul style="list-style-type: none"> Limits on executive remuneration Ability for State to introduce non-executive directors into company Dividend stopper on instrument
Govt/ Private Investors	<ul style="list-style-type: none"> Private Aim to reduce Government participation as much as possible with third party placement Security is transferable providing the Government with the ability to monetise / exit its investment in the future 	<ul style="list-style-type: none"> Private Aim to reduce Government participation as much as possible with third party placement Security is transferable providing the Government with the ability to monetise / exit its investment in the future 	<ul style="list-style-type: none"> Government This structure is unlikely to generate interest from third party investors Security is however transferable providing the Government with the ability to monetise / exit its investment in the future
Regulatory Capital Treatment	<ul style="list-style-type: none"> Non-innovative Tier 1 / Core Tier 1 (if the securities rank pari-passu with ordinary shares) 	<ul style="list-style-type: none"> Non-innovative Tier 1 / Core Tier 1 (if the securities rank pari-passu with ordinary shares) 	<ul style="list-style-type: none"> Core Tier 1, subject to IFSRA discussions unless structured as a new class of shares
Additional Considerations	<ul style="list-style-type: none"> An EGM will be required by the respective institutions in order to create a new class of shares, eligible of receiving core Tier 1 capital treatment 	<ul style="list-style-type: none"> An EGM will be required by the respective institutions in order to create a new class of shares, eligible of receiving core Tier 1 capital treatment 	<ul style="list-style-type: none"> An EGM will be required by the respective institutions in order to create a new class of shares
Underwriting Fee	<ul style="list-style-type: none"> Recent underwritten rights offerings from financial institutions have had total fees ranging from 1.30% to 3.15%. The UK government underwriting fees were 1.50% 		



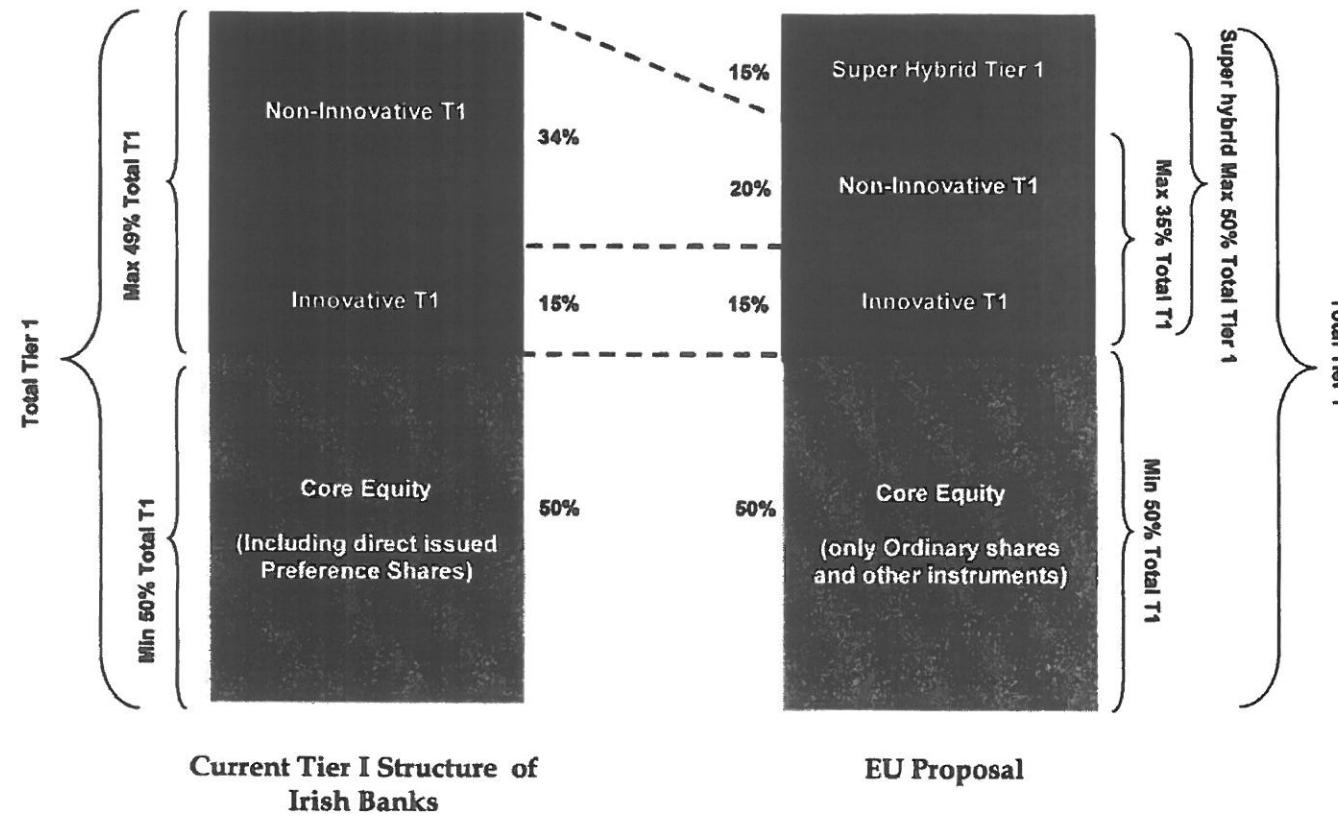
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Key Considerations For Irish Ministry Of Finance

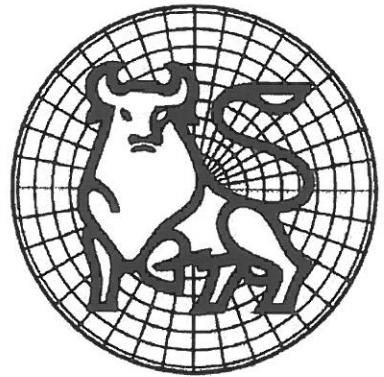
Considerations With Respect To Irish Regulatory Capital Limits

- Irish banks can issue up to 49% of their capital base in non dilutive tax deductible Hybrid Tier 1 instruments, currently referred to as Alternative Capital Instruments ("ACI")
- Irish direct issue preference shares are currently considered as Core Tier 1 but this is unlikely to apply going forward. We would therefore suggest issuing a new class of preferreds ranking *pari-passu* with ordinary capital, in line with recent transactions by other EU banks
- Going forward the European Capital Requirements Directive will impose a 50% restriction on hybrid Tier 1 instruments. However, whilst 35% of Total Tier 1 may be in non-dilutive format, the remaining 15% capacity is only available for hybrids which convert into core equity during emergencies (the options outlined on page 5 would fit into this category)

Irish Bank Regulatory Capital Baskets



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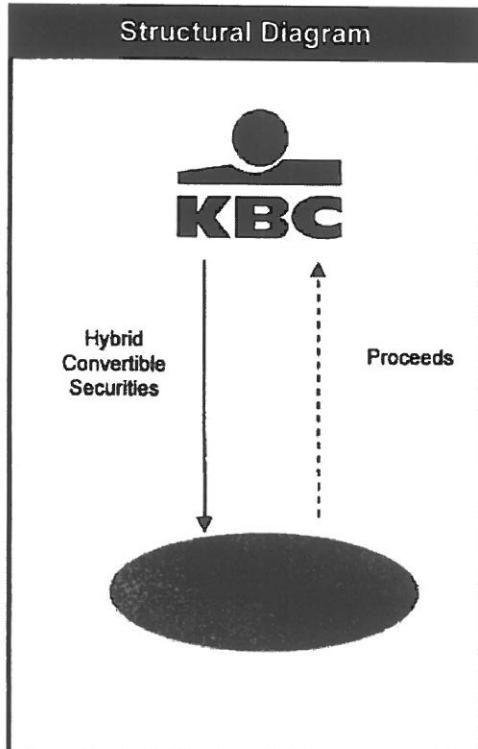
Detailed Summary of KBC & Swedbank Recapitalisation Instruments

Detailed Summary of KBC Recapitalisation Instrument

KBC €3.5bn Hybrid Convertible Securities

Summary Terms

Structural Diagram



- **Issuer / Investor:** KBC Group / Belgian State
- **Issue Date:** 27 October 2008
- **Amount:** €3.5bn
- **Regulatory Treatment:** Core Tier 1
- **Maturity /Step-up:** Perpetual /None
- **Coupon:** The annual cash coupon per security will be the higher of 2.51 euros (reflecting an interest rate of 8.5%) or an amount equal to 105% of the dividend paid on ordinary shares for the year 2008, 110% for the year 2009 and 115% from 2010 and onwards. No coupon will be paid, however, if no dividend is paid on ordinary shares.
- **Issuer Call:** KBC has the right to buy back all or some of the securities at any time at 150% of the issue price (cash settlement). The State can require the buyback to be settled by exchanging one security for one ordinary share
- **Conversion:** KBC is entitled to exchange all or some of the securities into ordinary shares on a one-for-one basis, from three years after the issuance onwards. If KBC chooses to do so, the State can opt to redeem the securities in cash at 100% of the issue price. All these transactions are subject to the approval of the CBFA, the financial-sector regulator
- **Ranking:** The securities are *pari passu* with ordinary shares
- **Transferability:** Non transferable
- **Voting Rights:** None
- **Corporate Governance:** The State has the right to nominate two members for KBC Group's Board of Directors, to be appointed at the next Annual General Meeting of Shareholders. A representative of the State will sit on the Audit Committee, the Remuneration and the Nomination Committee of the Board of Directors. They will have approval rights for a limited number of decisions, including those relating to share issuance or share buybacks (except in connection with this transaction), acquisitions whose value equal more than one quarter of KBC's share capital and reserves, and the remuneration policy for the members of the Executive Committee



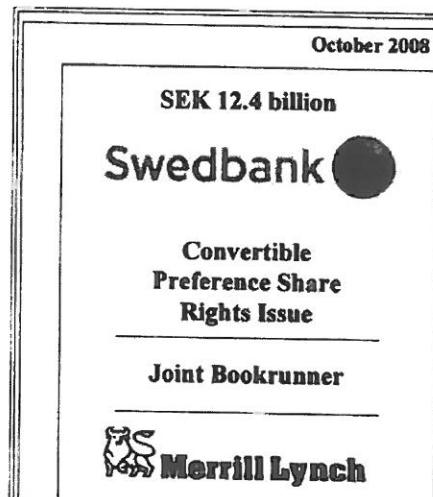
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Detailed Summary of Swedbank Recapitalisation Instrument

Swedbank SEK 12.4bn Mandatory Convertible Preference Shares

Merrill Lynch acted as joint bookrunner in the SEK 12.4bn mandatory convertible preference share rights issue for Swedbank

The innovative structure allowed Swedbank to secure proceeds in historically turbulent equity markets without government support



Summary Terms

Date:	27 October 2008
Issue Size:	SEK 12.4bn (USD 1.6bn)
Type:	Discounted convertible preference share rights issue 1 preference share for 2 existing ordinary shares
Status:	Core Tier 1
Issue Price:	100%
Mandatory Conversion:	After 4.5 years
Dividends:	The higher of 10% (SEK 4.80 per share) or an amount equal to dividends paid per ordinary share (5%, SEK 2.40 for 2009)
Conversion Price/Discount:	SEK 48.0 19% crude discount 14% discount to TERP
Coupon Deferability:	Yes, non-cumulative
Investor Call Option:	Every 6 months, non-redeemable
Investor Put Option:	None
Dividend Stopper:	None
Voting Rights:	Equal to ordinary shares

Overview

- On October 27th, Swedbank announced a SEK12.4bn (USD 1.6bn) convertible preference share rights issue to strengthen its capital ratios with fully guaranteed proceeds
 - Tier 1 Capital Ratio from 6.8% to 8.2%
 - Core Tier 1 from 5.8% to 7.2%
- The transaction is 100% underwritten by a group of current shareholders
 - Folksam, Savings Bank Foundations, Savings Banks, AMF Pension, AFA Insurance, SPK, Swedbank Employee Foundation, First and Second Swedish National Pensions Funds have all committed to underwriting the transaction
 - Despite the historically difficult market conditions, Swedbank was able to announce the transaction without the need for government support
- Securities have a right to an annual dividend of SEK 4.80 per share (10%), unless a higher dividend is paid on ordinary shares. Except for 2009, when securities have a right to a dividend of SEK 2.40
- It is the 10th rights issue over \$1bn Merrill Lynch has book-run in 2008 in the financial space after BCP, Monte Paschi di Sienna, Société Générale, RBS (x2), Vienna Insurance Group, Natixis and Lloyds and UniCredit



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Appendix 1: Summary of European Bank Re-Capitalisations

Summary of European Bank Re-Capitalisations

Precedent Transactions

Some issuers are already into their 2nd or 3rd round of recapitalizations

Core Tier 1 continues to be the primary focus of the recapitalizations

The Core Tier 1 instruments range from straight equity to non-dilutive hybrids depending on specific country and issuer considerations

Some issuers have relied on a variety of instruments to strengthen their balance sheets depending on the size of their capitalization requirements (e.g. Lloyds, RBS, HBOS, Barclays, Commerzbank and CS)

Local governments have been instrumental in assisting recapitalizations

	Non- Dilutive Hybrid	Redeemable Convertible Preferred	Non-Redeemable Mandatory Convertible ⁽¹⁾	Equity
Core Tier 1	COMMERZBANK	ING KBC AEGON ERSTE Swedbank UniCredit Group BARCLAYS	BARCLAYS	COMMERZBANK Lloyds TSB The Royal Bank of Scotland Group plc DERIA BARCLAYS NATIXIS FORTIS Deutsche Bank Postbank
Non Core Tier 1	HBOS Lloyds TSB The Royal Bank of Scotland Group plc CREDIT SUISSE	BARCLAYS	CREDIT SUISSE UBS	

(1) Including Mandatory Convertible Securities ("MCS") and Convertible And Subordinated Hybrid Equity-linked Securities ("CASHES")



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Summary of European Bank Re-Capitalisations

Precedent Transactions

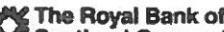
Maximising Rating Agency Equity Credit In Re-Capitalisations

Financial institutions have focussed on achieving the optimum rating agency treatment with respect to their capital injections

Most preferred-type instruments fall within S&P's ATE (Intermediate) Basket

Recognising the strategic nature of the government as an investor and the quality of the capital, S&P has classified the ING, Aegon and KBC deals within the ATE (High) Basket alongside with short dated mandatory convertibles

Only, pure equity instruments are eligible for ACE credit

	Non- Dilutive Hybrid	Redeemable Convertible Preferred	Non-Redeemable Mandatory Convertible ⁽¹⁾	Equity
ACE				COMMERZBANK  Lloyds TSB  DEUTSCHE BANK  BARCLAYS  NATIXIS  FORTIS  Deutsche Bank  Postbank 
ATE High / 50% of ACE		ING  AEGON  KBC 	CREDIT SUISSE  UBS  BARCLAYS 	
ATE Intermediate / 33 % of ACE	COMMERZBANK  Lloyds TSB  The Royal Bank of Scotland Group plc  CREDIT SUISSE 	BARCLAYS  ERSTE  Swedbank  UniCredit Group 		

⁽¹⁾ Including Mandatory Convertible Securities ("MCS") and Convertible And Subordinated Hybrid Equity-linked Securities ("CASHES")



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Summary of European Bank Re-Capitalisations

Summary Of Key Restrictions Imposed

Summary of Key Restrictions Imposed Within Different Securities (Excluding Equity) ⁽¹⁾

	Negative Restrictions					Positive Features	
	Restriction on Dividends	Restrictions on Management Remuneration	Board Representation	Future Lending Requirements	Voting Rights Attached	Dilutive	Flexibility To Repurchase / Redeem
Non-Dilutive Preferred Instruments		✓		✓			✓
	✓	✓	✓	✓			✓
	✓	✓				(3)	✓
		✓	✓			(3)	✓
		✓		✓		(3)	
Redeemable & Non-Re redeemable Preferreds		✓				✓	✓
		✓	✓			✓	
						✓	
						✓	✓
						✓ (2)	✓ (2)
							✓
Mandatory Convertible Preferreds		✓				✓	
						✓	
						✓ (2)	✓ (2)
							✓

(1) Source: Merrill Lynch; (2) Mitigated by shareholder's clawback; (3) Conversion at the issuer's option



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Summary of European Bank Re-Capitalisations

Non-Dilutive Preferred

CREDIT SUISSE		COMMERZBANK		
16 October 2008 ⁽¹⁾		03 November 2008 ⁽²⁾	03 November 2008 ⁽³⁾	No Issuance ⁽⁵⁾
Type of Securities	<ul style="list-style-type: none"> ■ Non-dilutive hybrid Tier 1 ■ Non-Innovative Tier 1; S&P 33% 	<ul style="list-style-type: none"> ■ Silent Participation ■ Core Tier 1; S&P 33% e/ 	<ul style="list-style-type: none"> ■ Non-innovative Tier 1 Preference Shares ■ Non-Innovative Tier 1; S&P 33% e/ 	<ul style="list-style-type: none"> ■ Deeply Subordinated Notes (TSS) ■ Non-Innovative Tier 1; S&P 33% e/
Size	<ul style="list-style-type: none"> ■ CHF 5.5bn approx. (two tranches USD / CHF, sizes not specified) 	<ul style="list-style-type: none"> ■ € 8.2bn in 2 tranches of €4.1bn each 	<ul style="list-style-type: none"> ■ RBS not yet determined, Lloyds £ 1bn, HBOS £ 3bn 	<ul style="list-style-type: none"> ■ Banque Populaires €0.95bn, BNPP €2.55bn, Caisses d'Epargnes €1.1bn, Credit Agricole €3bn, Credit Mutuel €1.2bn, Soc Gen €1.7bn
Maturity	<ul style="list-style-type: none"> ■ Perp / NCS 	<ul style="list-style-type: none"> ■ Perp / After 5 Fiscal Years 	<ul style="list-style-type: none"> ■ Perp / NC5. Repurchase 0-5yo at 101%, thereafter at a market price. Repurchase subject to replacement capital 	<ul style="list-style-type: none"> ■ Perp / NC5
Coupon	<ul style="list-style-type: none"> ■ On the USD tranche: 11% p.a. paid annually ■ On the CHF tranche: 10% p.a. paid annually 	<ul style="list-style-type: none"> ■ Tranche 1: 8.5% base + 0.5% for every €0.25 dividend paid (from 2010) ■ Tranche 2: 5.5% base + 0.5% for every €0.25 dividend paid (from 2010) 	<ul style="list-style-type: none"> ■ 12% p.a. semi-annually to yr 5; thereafter 3m LIBOR + 7% 	<ul style="list-style-type: none"> ■ OAT 5yrs + 400bps
Additional Characteristics/Information	<ul style="list-style-type: none"> ■ No voting rights attached ■ No ability to nominate board members ■ No specifics on the transferability ■ No limitations on bonuses ■ No compensation restrictions ■ No constraints on dividend policies <p>■ No voting rights attached</p> <p>■ No specifics on the ability to nominate board members</p> <p>■ No specifics on the transferability</p> <p>■ No bonuses in 08 & 09 for Executive Board members</p> <p>■ Compensation restrictions</p> <p>■ CMZB may not pay any dividends in 2009 and 2010</p> <p>■ In relation to Tranche 2, redemption amount of SP increases for every % share price increase over €10 (capped at share price of €14.5, equalling a repurchase amount of 145%)</p>			
Investor	<ul style="list-style-type: none"> ■ Qatar Investment Authority 	<ul style="list-style-type: none"> ■ German State Fund 	<ul style="list-style-type: none"> ■ HM Treasury 	<ul style="list-style-type: none"> ■ French State
Economics	<ul style="list-style-type: none"> ■ Theoretical Value: 81% 	<ul style="list-style-type: none"> ■ Theoretical Value: 62% 	<ul style="list-style-type: none"> ■ Theoretical Value: 86% 	<ul style="list-style-type: none"> ■ Theoretical Value: 74%
<p>1. Credit Suisse Press Release 16 Oct 2008 2. Commerzbank Press Release 03 Nov 2008 3. Lloyds TSB Press Release 3 Nov 2008</p> <p>4. FSA "Treasury statement on financial support to the banking industry" 13 Oct 2008 Sources: BNP Paribas "BNP Paribas s'engage pour le financement de l'économie réelle" 21 Oct. 2008 / Ministère des Finances, "L'Etat est prêt à souscrire à des titres subordonnés pour 10,5 milliards d'euros pour financer l'économie" 20 Oct. 2008</p>				



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Summary of European Bank Re-Capitalisations

Redeemable Convertible Preferred

Convertible at Issuer's option						Convertible at Holder's option											
ING			AEGON			ERSTE			KBC			BARCLAYS					
		20 October 2008			28 October 2008			30 October 2008			27 October 2008			31 October 2008			14 Oct 2008
Type of Securities		<ul style="list-style-type: none"> Preferred Convertible Core Tier 1; S&P 50% e/ 		<ul style="list-style-type: none"> Preferred Convertible Core Tier 1; S&P 50% c/ 		<ul style="list-style-type: none"> Participation Capital Instrument Core Tier 1; S&P 33% e/ 		<ul style="list-style-type: none"> Preferred Convertible Core Tier 1; S&P 50% e/ 		<ul style="list-style-type: none"> Reserve Capital Instruments "RCIs" plus warrants Innovative Tier 1; S&P 33% e/ 		<ul style="list-style-type: none"> Senior Preferred Shares Unrestricted Tier 1; S&P33% c/ 					
Size		€10.0 billion		€3.0 billion		€2.7 billion		€3.5 billion		£ 3.0 billion		Total facility USD 250bn					
Maturity		<ul style="list-style-type: none"> Perp. Callable at any time at 150% premium 		<ul style="list-style-type: none"> Perp. 1/3rd of bonds between 100% to 113% before year 1 and 150% onwards 		<ul style="list-style-type: none"> Perp/ NC5 		<ul style="list-style-type: none"> Perp. Callable at any time at 150% premium. Dutch State can require delivery of shares instead 		<ul style="list-style-type: none"> Perp/ NC11. Warrants expire on yr 5 		<ul style="list-style-type: none"> Perp / NC3. Warrants expire on yr 10 					
Coupon		<ul style="list-style-type: none"> Greater of 8.5% or a multiple of divs on common as follows: 110% of 2008, 120% for 2009 and 125% onwards 		<ul style="list-style-type: none"> Greater of 8.5% or a multiple of divs on common as follows: 110% of 2009 dividends, 120% for 2010 and 125% onwards 		8.0%		<ul style="list-style-type: none"> Greater of 8.5% or a multiple of divs on common as follows: 105% of 2008, 110% for 2009 and 115% onwards 		<ul style="list-style-type: none"> 14.0% until 2019; 3-mo LIBOR + 13.4% thereafter 		<ul style="list-style-type: none"> 5% p.a. until year 5, thereafter at 9% p.a., payable quarterly in arrear 					
Conversion Price Premium		<ul style="list-style-type: none"> €10.0⁽¹⁾; 36% Premium Convertible at ING's option from yr 3 (subject to EGM approval), Dutch State can opt for repayment in cash at par 		<ul style="list-style-type: none"> €4.0⁽²⁾; 18% Premium Convertible at Aegon's option from yr 3, Dutch State can opt for repayment in cash at par 		<ul style="list-style-type: none"> Convertible after year 5 at the Issuer's option 		<ul style="list-style-type: none"> €29.50⁽³⁾; 10% Premium Convertible at KBC's option from yr 3, Dutch State can opt for repayment in cash at par 		<ul style="list-style-type: none"> £1.86 for warrants⁽⁴⁾; 3.6% Discount 		<ul style="list-style-type: none"> Exercise price equal to 20 trading day trailing average 					
Divisive Effect		<ul style="list-style-type: none"> 1,000 million (48.0% of shares out if converted) 		<ul style="list-style-type: none"> 750 million (48.2% of shares out if converted) 		<ul style="list-style-type: none"> No specific details 		<ul style="list-style-type: none"> 119 million (33.4% of shares out if converted) 		<ul style="list-style-type: none"> 1,517 million shares underlying warrants (18.1% of shares out) 		<ul style="list-style-type: none"> To be specified 					
Additional Characteristics Information		<ul style="list-style-type: none"> No voting rights attached Ability to nominate 2 members at ING's Supervisory Board Not transferable without ING's and Dutch State's consent No bonuses payable to Executive Board members No final dividend 2008 		<ul style="list-style-type: none"> No voting rights attached Ability to nominate 2 members at Aegon's Supervisory Board Not transferable No bonuses payable to Executive Board members No final dividend 2008 		<ul style="list-style-type: none"> No voting rights attached No ability to nominate board members Not transferable Board members renounced voluntarily 2008 bonus Compensation restrictions Requirements on minimum lending 		<ul style="list-style-type: none"> No voting rights attached Ability to nominate 2 members to KBC's Board of Directors Not transferable No bonuses payable to Executive Board members No dividend payable for 2008 		<ul style="list-style-type: none"> No voting rights attached No ability to nominate board members No specifics on the transferability No limitation on bonuses No compensation restrictions No constraints on dividend policies Investors will obtain GBP 3bn worth of warrants 		<ul style="list-style-type: none"> No voting rights attached Ability to nominate 2 board members in certain circumstances Transferable Compensation restrictions UST consent for (i) any increase in common dividends or (ii) any share repurchases (subject to limitations) until 3rd anniversary 					
Investor		Dutch State		Dutch State via Aegon Vereniging		Austrian State		Belgian State		Abu Dhabi and Qatar based investors		US State					
Economics		Theoretical Value: 103%		Theoretical Value: 102%		Theoretical Value: 62%		Theoretical Value: 95%		Theoretical Value: 145%		Theoretical Value: C. 80%					

- Dividend yield based on 09c Bloomberg consensus estimates, based on reference price
- Reference price set at closing price before announcement, October 3rd 2008
- 36% premium to closing price before announcement, October 17th
- 10% premium to closing price before announcement, October 24th

- 18% premium to closing price before announcement, October 27th
- Closing price on day before announcement October 30th GBP 2 0525



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Summary of European Bank Re-Capitalisations

Non Redeemable and Mandatory Convertibles

Redeemable		Non-Redeemable			
	07 October 2008		16 October 2008		16 October 2008
Type of Securities	<ul style="list-style-type: none"> CASHES perpetual Core Tier 1; S&P 33% e 	<ul style="list-style-type: none"> Mandatory Convertible "MCS" Core Tier 1; S&P 50% c/ 	<ul style="list-style-type: none"> Mandatory Convertible "MCS" Core Tier 1; S&P 50% c/ 	<ul style="list-style-type: none"> Mandatory Convertible Preference Shares Core Tier 1; S&P 50% e/ 	<ul style="list-style-type: none"> Mandatory Convertible Notes "MCN" Core Tier 1; S&P 50% e/
Size	€3.0 billion	CHF 1.7bn	CHF 6.0 billion	SEK 12.4 billion	£ 4.3 billion
Maturity	Undated	1 year for MCS	30 months	4.5 years	8 months
Coupon ¹	<ul style="list-style-type: none"> 3m Euribor + 4.50% Dividend pass-through above 8.0% yield (vs. 09e dividend yield of 7.6%) 	<ul style="list-style-type: none"> MCS coupon: N/A (vs. 09e dividend yield of 5.7%) 	<ul style="list-style-type: none"> 12.5% p.a., payable annually (vs. 09e dividend yield of 5.5%) 	<ul style="list-style-type: none"> Dividend set at the higher of SEK 4.80 per share (10% of subscription price) or dividend paid per ordinary share (vs. 09e dividend yield of 14.7% (SEK 7.04)) 	<ul style="list-style-type: none"> Coupon: 9.75% (vs. 09e dividend yield of 8.5% (£ 0.174))
Issuer Call	<ul style="list-style-type: none"> Automatic exchange after 7 years, when trading 150% above exchange price 	N/A	<ul style="list-style-type: none"> At any time at maximum exchange ratio (all interest payable until maturity) 	<ul style="list-style-type: none"> None, other than mandatory conversion at maturity 	None
Conversion Price/ Premium	€3.083 ⁽⁶⁾ ; 0% Premium	Reference price CHF 34.26 ⁽²⁾ , MCS strikes: N/A	Minimum reference price CHF 18.21 ⁽³⁾ ; MCS strikes: 100% / 117%	SEK 48.0 ⁽⁴⁾ ; 19% crude discount. Convertible at the option of the holder every 6 months	£1.52; 25.3% discount ⁽⁵⁾
Dilutive Effect	973 million (7.3% of shares out)	50 million (4.4% of shares out)	329 million (11.2% of shares out)	258 million (50.0% of shares out)	2,805 million (33.5% of shares out)
Additional Characteristics/ Information	<ul style="list-style-type: none"> No voting rights attached No ability to nominate board members Transferable No limitation on bonuses No compensation restrictions No constraints on dividend policies Clawback structure 	<ul style="list-style-type: none"> No voting rights attached No ability to nominate board members Transferable No limitations on bonuses No compensation restrictions No constraints on dividend policies Additionally sale of CHF 3,200 million treasury shares 	<ul style="list-style-type: none"> No voting rights attached No ability to nominate board members Transferable Limitations on bonuses Compensation restrictions No constraints on dividend policies Subject to EGM approval 	<ul style="list-style-type: none"> Voting rights attached No ability to nominate board members Transferable No limitations on bonuses No compensation restrictions No constraints on dividend policies Issue of securities by way of discounted preference share rights issue (1 : 2 rights issue) Discount to TERP 13.8% 	<ul style="list-style-type: none"> No voting rights attached No ability to nominate board members No specifics on the transferability No limitation on bonuses No compensation restrictions No constraints on dividend policies Offering concurrent with £3.8bn of RCIs plus warrants
Investor	Private placement to existing shareholders	Qatar Holding LLC	Swiss Confederation	Private placement to existing shareholders	Abu Dhabi and Qatar based investors. £1.5bn MCN offered to public
Economics	Theoretical Value: 102%	Theoretical Value: N/A	Theoretical Value: 105%	Theoretical Value: 104%	Theoretical Value: 140%

1. Dividend yield based on 09e Bloomberg consensus estimates, based on reference price

2. Reference price set at closing price on October 10th 20083. Reference price set at the lower of share price on October 15th and average over period until EGM4. 19% discount to closing price on day before announcement, October 24th5. Closing price on day before announcement October 30th GBP 2.0525

6. Reference price set at closing price before announcement, October 3rd 2008



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Summary of European Bank Re-Capitalisations Straight Equity

COMMERZBANK		BARCLAYS		Lloyds TSB		Deutsche Bank		NATIXIS	
8 September 2008		18 September 2008		19 September 2008		22 September 2008		25 September 2008	
Size	■ €1.1bn	■ £701m	■ £788m	■ €2.2bn				■ €3.7bn	
Offer Type	■ Primary AGT SM		■ Primary AGT SM		■ Rights issue				
% of Share Capital	■ 9.9% of pre existing share capital ■ 9.0% of enlarged share capital	■ 2.8% of pre existing share capital ■ 2.7% of enlarged share capital	■ 5.0% of pre existing share capital ■ 4.8% of enlarged share capital	■ 7.5% of pre existing share capital ■ 7.0% of enlarged share capital		■ 130.0% of pre existing share capital ■ 57.0% of enlarged share capital			
Offer Price/ Discount	■ €17.00 ■ 0.1% disc. to 5 Sep close of €17.015	■ £3.10 ■ 2.4% disc. to 17 Sep close of £3.18	■ £2.70 ■ 13.7% prem. to 18 Sep close of £2.37	■ €55.00 ■ 5.0% disc. to 19 Sep close of €57.88		■ €2.25 ■ 61.5% disc. to last close pre terms on 3 Sep of €3.84 ■ 41.0% disc. to TERP of €3.81			
Back Stop Underwriter	■ None	■ None	■ None	■ None		■ The Strategic Shareholders, BFBP and CNCE, who owned 69.8% of the Company, both committed to subscribe pro rata ■ Remainder underwritten by a bank syndicate			
Pre-Emptive Offer / Clawback	■ None	■ None	■ None	■ None		■ Pre-emptive offer			
Restrictions & Limitations	■ None	■ Shares not entitled to interim dividend declared 7 August 2008	■ None	■ None		■ None		■ None	
Board Representation	■ None	■ None	■ None	■ None		■ None		■ None	
Lock-Up	■ 90 days on the Issuer	■ None	■ 90 days on the Issuer	■ None		■ 120 days on the Issuer ■ 180 days on Strategic Shareholders			



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Summary of European Bank Re-Capitalisations

Straight Equity

FORTIS		DEXIA	RBS	Lloyds TSB	HBOS plc	
29 September 2008		30 September 2008	13 October 2008	13 October 2008	13 October 2008	27 October 2008
Size	■ €11,200m	■ €6,400m	■ £20,000m	■ £5,500m	■ £11,500m	■ €1,000m
Offer Type	<ul style="list-style-type: none"> ■ Cash injection from Belgian Gov, Dutch Gov and Luxembourg Gov 	<ul style="list-style-type: none"> ■ Cash injection from Belgian federal Gov and the 3 Regions (€1bn), French Gov (€1bn), CDC (€2bn) and Shareholders (€1bn) 	<ul style="list-style-type: none"> ■ £15bn in the form of an open offer to existing shareholders and £5bn in the form of preference shares with a 12% coupon 	<ul style="list-style-type: none"> ■ £4.5bn in the form of an open offer to existing shareholders and £1bn in the form of preference shares with a 12% coupon 	<ul style="list-style-type: none"> ■ £8.5bn in the form of an open offer to existing shareholders and £3bn in the form of preference shares 	<ul style="list-style-type: none"> ■ Rights issue
% of Share Capital	<ul style="list-style-type: none"> ■ Belgium bought 49% of the Belgian banking unit for €4.7bn (will sell 75% to BNPP) ■ The Netherlands paid €4bn for a similar stake in the Dutch banking unit ■ Luxembourg provided a €2.5bn loan convertible into 49% of the Luxembourg banking unit 	<ul style="list-style-type: none"> ■ Ownership structure: Belgian Federal Gov and the 3 Regions 11.4%, Shareholders 34.2%, French Gov and CDC 25.0% and Free float 29.4% ■ Luxembourg Gov will invest €378m in Dexia Banque Internationale à Luxembourg SA in the form of convertible bonds 	<ul style="list-style-type: none"> ■ c.138% existing issued share capital ■ c.58% enlarged issued share capital 	<ul style="list-style-type: none"> ■ c.43.5% of existing issued share capital ■ c.30.3% enlarged issued share capital 	<ul style="list-style-type: none"> ■ c.187% of existing issued share capital ■ c.65% of enlarged issued share capital 	<ul style="list-style-type: none"> ■ c.10% of existing issued share capital
Offer Price/ Discount	<ul style="list-style-type: none"> ■ n.a. 	<ul style="list-style-type: none"> ■ Investors received shares at a price of €9.90 equal to the average of the previous 30 days closing price 	<ul style="list-style-type: none"> ■ 65.5p per share ■ 0.5% premium to 3 November closing price of 65.2p ■ 8.6% discount to 12 October closing price of 71.7p 	<ul style="list-style-type: none"> ■ 173.3p per share ■ 12.4% discount to 31 October closing price of 197.8p ■ 8.5% discount to 10 October closing price of 189.4p 	<ul style="list-style-type: none"> ■ 113.6p per share ■ 8.5% discount to 10 October closing price of 124.2p 	<ul style="list-style-type: none"> ■ €18.25 per share ■ 2.0% gross discount to 24 October closing price of €18.62
Back Stop Underwriter	<ul style="list-style-type: none"> ■ n.a. 	<ul style="list-style-type: none"> ■ n.a. 	<ul style="list-style-type: none"> ■ Backstopped by HM Treasury 	<ul style="list-style-type: none"> ■ Backstopped by HM Treasury 	<ul style="list-style-type: none"> ■ Backstopped by HM Treasury 	<ul style="list-style-type: none"> ■ Fully underwritten by main shareholder Deutsche Post AG
Pre-Emptive Offer / Clawback	<ul style="list-style-type: none"> ■ n.a. 	<ul style="list-style-type: none"> ■ n.a. 	<ul style="list-style-type: none"> ■ Open offer with clawback 	<ul style="list-style-type: none"> ■ Open offer with clawback 	<ul style="list-style-type: none"> ■ Open offer with clawback 	<ul style="list-style-type: none"> ■ Pre-emptive rights
Restrictions & Limitations	<ul style="list-style-type: none"> ■ TBD at the EGM to be held by year end 	<ul style="list-style-type: none"> ■ TBD 	<ul style="list-style-type: none"> ■ No dividend paid on the Ordinary Shares until the Preference Shares are no longer in issue unless otherwise agreed by HMT ■ No bonus in 2008 and shares only in 2009 for Directors 	<ul style="list-style-type: none"> ■ No dividend paid on the Lloyds TSB Shares while any of the Preference Shares are outstanding, unless otherwise agreed by HMT ■ No bonus in cash for Directors in 2008 	<ul style="list-style-type: none"> ■ No dividend may be paid on the HBOS Shares while any of the Preference Shares are outstanding, unless otherwise agreed by HMT ■ No remuneration for Directors in 2008 	<ul style="list-style-type: none"> ■ Proposal to the next AGM in April 2009 not to distribute any dividends for 2008
Board Representation	<ul style="list-style-type: none"> ■ Chairman to step down ■ A significant number of govt representatives will seat on the Board 	<ul style="list-style-type: none"> ■ French Gov has one board seat and CDC two 	<ul style="list-style-type: none"> ■ CEO change ■ HM Treasury will appoint 3 new independent directors 	<ul style="list-style-type: none"> ■ HMT will appoint 2 new independent directors after completion of the combination 	<ul style="list-style-type: none"> ■ n.a. (see Lloyds) 	<ul style="list-style-type: none"> ■ Deutsche Post AG seats on the Supervisory Board
Lock-Up	<ul style="list-style-type: none"> ■ None 	<ul style="list-style-type: none"> ■ None 	<ul style="list-style-type: none"> ■ None 	<ul style="list-style-type: none"> ■ None 	<ul style="list-style-type: none"> ■ None 	<ul style="list-style-type: none"> ■ TBD

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Appendix 2: Summary of Irish Regulatory Framework

Summary of Irish Regulatory Framework

Summary of Regulatory Capital Instruments

Features	Lower Tier 2		Upper Tier 2		Alternative Capital Instruments	Core Tier 1
	Structure	Maturity	Structure	Maturity		
Structure	Direct issued		Direct issued		SPV Issued Guaranteed	Direct issued preference shares
Maturity	Dated – 5 years minimum		Perpetual. Not callable before 5 years		Perpetual. Not callable before 5 years	Perpetual. Not callable before 5 years
Step-up	Maximum of 100bps over life of the instrument or 50 bps during the first ten years life of the debt. No step-up in first 5 years		Maximum of 100bps over life of the instrument or 50 bps during the first ten years life of the debt. No step-up in first 5 years		Innovative ACI: Up to 15% of Tier 1. Step-up on year 10. Maximum of 100bps Non-Innovative ACI: Up to 49% (less innovative basket) of Tier 1. No step-up	No step-up
Optional Deferral / Suspension	No		Yes		Yes, non-cumulative	Yes, non-cumulative
Mandatory Deferral / Suspension	No		No		Subject to distributable reserves	Subject to distributable reserves
Dividend Pusher	Yes		Yes		No	No
Dividend Stopper	No		No		Yes	Yes
Ranking	Junior to unsubordinated debt, <i>pari passu</i> with undated or perpetual subordinated debt and senior to all classes of share capital		Junior to unsubordinated debt, <i>pari passu</i> with undated or perpetual subordinated debt and senior to all classes of share capital		Pari passu with preference shares of the Issuer or the Guarantor and senior to all classes of share capital	Pari passu with preference shares of the Issuer or the Guarantor and senior to all classes of share capital
Cumulative	Yes. Cash settled.		Yes. Cash settled.		No	No
IFRS Accounting	Debt		Debt or Equity		Debt or Equity	Debt or Equity
Tax	Deductible		Deductible		Deductible	Not deductible

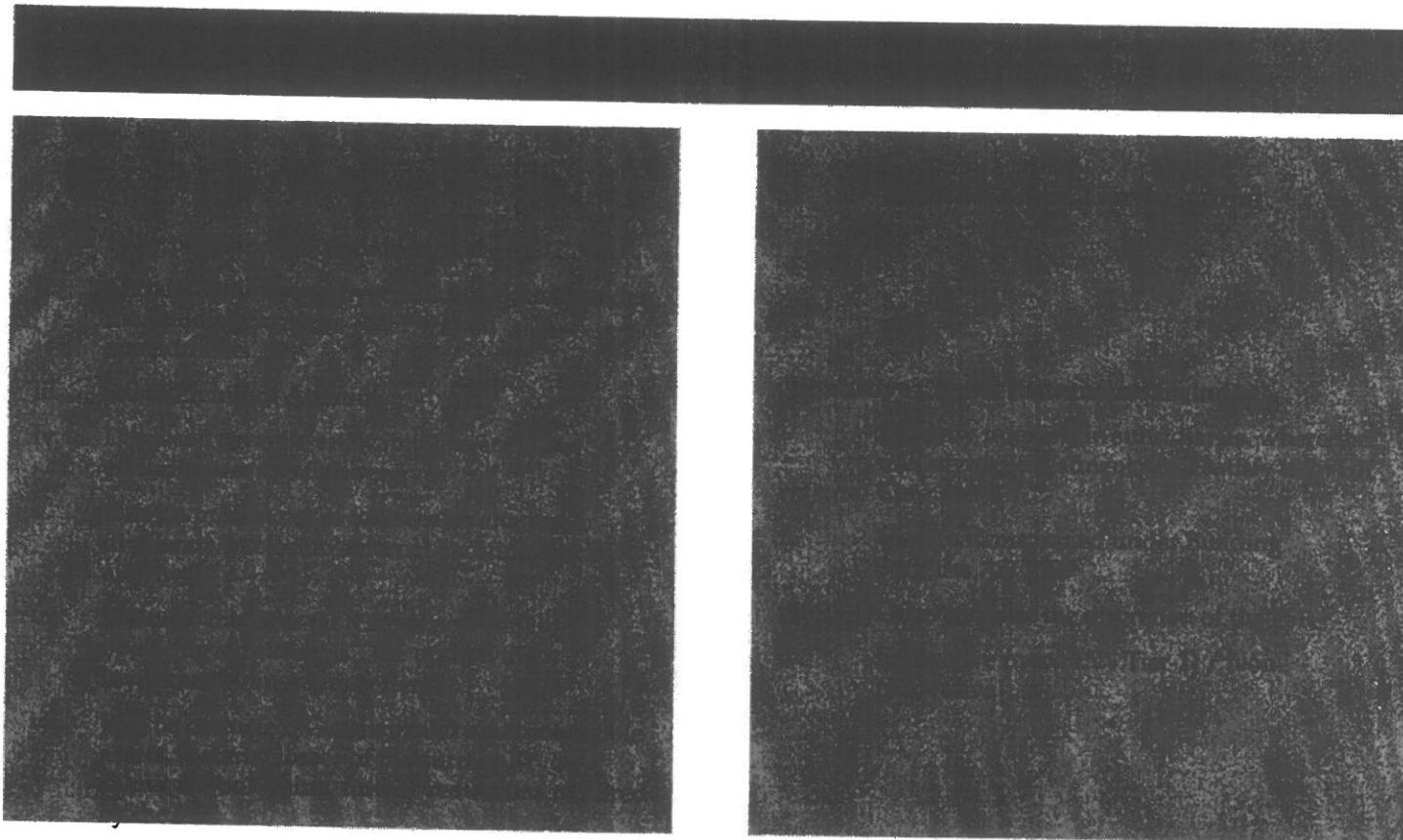


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Summary of Irish Regulatory Framework

Eligibility as Tier-1 Capital in Ireland

Irish Regulatory Tier I Criteria



(1) Not all items issued under the Building Societies Act and amendments will be eligible

(2) Explicitly excludes SPV or other company structures created for capital purposes. In addition, the use of a capital issue through an operating subsidiary, solely for the purpose to raise capital on a consolidated basis to the parent Applicant or where the capital raised does not support the risk assets of the operating subsidiary, will also normally be classified as Non-Core Tier-1 Capital

(3) Underlying investment refers to the equity share capital of the minority interest



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ON THE LIKELY EXTENT OF FALLS IN IRISH HOUSE PRICES

*Morgan Kelly**

Abstract

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

1. Introduction

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

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

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

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

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

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

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

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

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

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

2. Economic Theory

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

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

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

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

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

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

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

3. Mean Reversion in House Prices

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

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

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

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

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

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

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

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

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

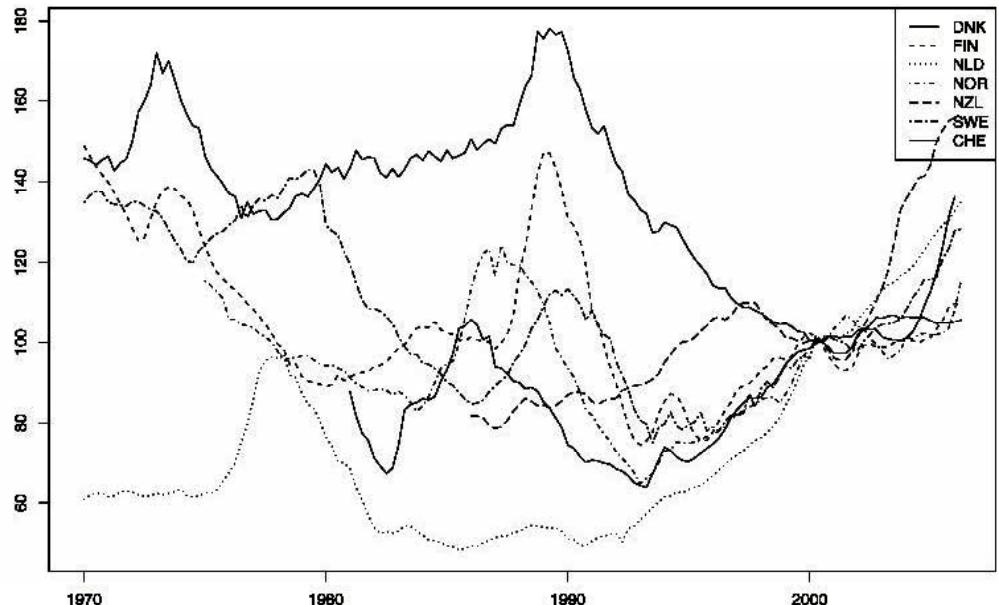


Figure 2 plots the size of increase in house prices for 17 OECD economies, against its subsequent fall.² For clarity, we exclude other variables such as interest rates that other studies find to have limited explanatory power for house prices: we are focusing on weak form efficiency of housing markets.

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

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

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

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

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

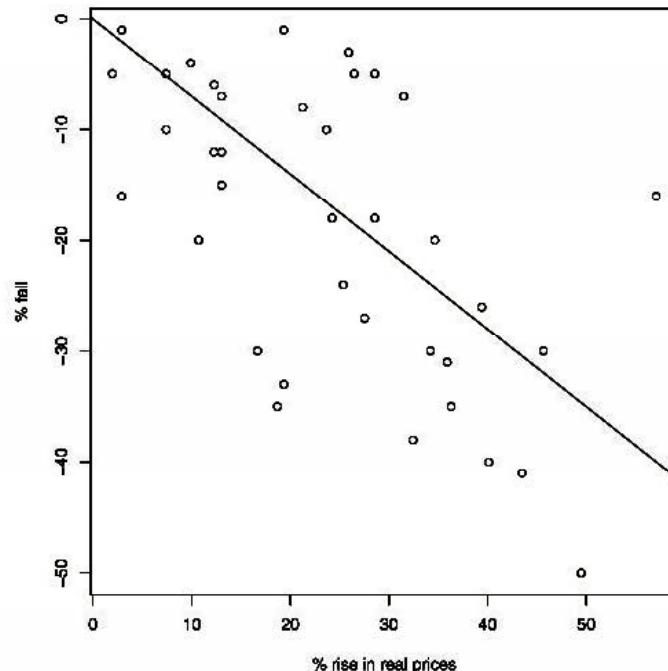


Table 2 shows a regression of the percentage fall in house prices against their previous rise, both including and excluding the Spanish early-1990s outlier, for real house prices and the house price to income ratio. The slope of -0.7 for real house price means that 70 per cent of the rise during a boom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

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

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

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

	Intercept	Initial Rise	SER	R ₂	BP	N
Real House Prices						
All	-0.0489 (0.0363)	-0.5746** (0.131)	0.1085	0.3548	0.022	37
Excl. Spain	-0.0252 (0.0356)	-0.7025** (0.1347)	0.1021	0.4445	0.483	36
House Prices Relative to Disposable Income						
All	-0.1168** (0.0389)	-0.6115** (0.1899)	0.1275	0.219	0.187	39
Excl. Spain	-0.104** (0.0395)	-0.713** (0.2013)	0.1259	0.2584	0.428	38

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

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

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

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

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

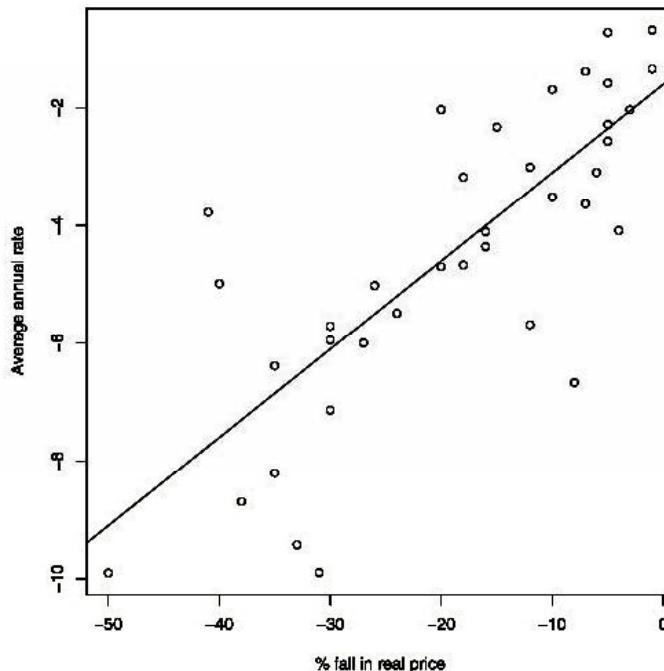


Table 3: Connection Between Annual Rate of Decline and Magnitude of House Price Falls

Intercept	Price Fall	SER	R ₂	BP	N
-1.6784** (0.4709)	0.1494** (0.0206)	1.6434	0.6014	0.121	37

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

4. The Irish Housing Bubble, Causes and Consequences

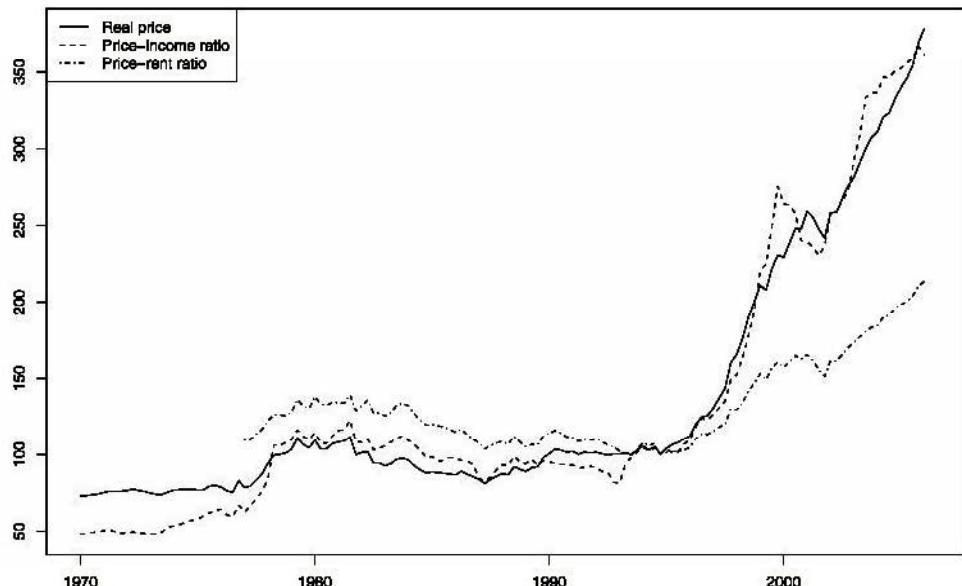
The evidence of nearly 40 cycles in house prices for 17 OECD economies since 1970 shows that real house prices typically give up about 70 per cent of their rise in the subsequent fall, and that these falls occur slowly.

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

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

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

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



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

$$P = \frac{vy}{r - g}$$

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

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

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

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

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

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

5. International Perspectives on the Irish Housing Bubble

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

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

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

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

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

5.1 FUNDAMENTAL REGRESSIONS

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

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

5.2 MACROECONOMIC CONSEQUENCES

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

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

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

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

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

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

6. Conclusions

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

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

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

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

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To: Secretary General } for info
Mr Cardiff
Ms Herbet

(12)

Note for the Minister's information
Meeting with Merrill Lynch International Bank
13 November 2008 (4pm)

Attendance

Mike Ryan CEO
Paul Byrne Bank Treasurer

Background

Meeting is a further follow up to Merrill Lynch's request to join the Bank Guarantee Scheme.

Merrill Lynch wrote to you shortly after the Guarantee was announced by the Government seeking admission to the Scheme.

This application together with those received from a broad range of other financial institutions has been submitted to you with a recommendation that you do not admit them to the Scheme :

Merrill Lynch may make the case that in view of the range of guarantee arrangements that have been put in place across the EU, they are competitively disadvantaged on account of not being able to avail of the Irish guarantee.

They may refer to a loss of large corporate deposits to guaranteed institutions and the lack of a level playing field.

Merrill Lynch may also make the point that the international (IFSC) sector generally is disadvantaged from the Government's approach which may have adverse implications for the growth and development of the international financial sector.

Suggested Speaking Points

- The bank guarantee Scheme was put in place at the end of September to address the very severe liquidity shortage that the domestic Irish banks were experiencing at that time.
- This was essential in order to safeguard the Irish banking system overall.
- The Government's rationale for taking such a significant step was the need to ensure that the financing and credit needs of the economy could be met.
- The Scheme contains very significant restrictions on the commercial conduct of the covered institutions – a substantial charge is paid for the benefit of the Scheme.
- [I have carefully considered the case for extending eligibility for membership of the Scheme.
- The legislation providing for the guarantee limits its use to situations in which the systemic stability of the Irish financial system is at risk – the strict conditions attached to the Scheme rule out competitive abuses.
- I have also concluded that given the scale of the international sector and the additional liabilities potentially involved might undermine the market credibility of the guarantee to the detriment of the fund raising capacity of the Irish banks]

The National Recovery Plan 2011-2014

What does the National Recovery Plan do?

The Plan provides a blueprint for a return to sustainable growth in our economy. In particular, it:

- Sets out the measures that will be taken to restore order to our public finances.
- Identifies the areas of economic activity which will provide growth and employment in the recovery.
- Specifies the reforms the Government will implement to accelerate growth in those key sectors.

Why do we need this Plan?

The gap between Government receipts and spending will be €18.5 billion in 2010.

- This gap must be filled by borrowing. Unless the rate of borrowing is reduced, the burden of debt service will absorb a rapidly increasing proportion of tax revenue.
- Moving towards a balanced budget is a prerequisite for future economic growth.

Reducing the budget deficit is necessary, but it will not, by itself, solve our economic difficulties. We must grow our economy by improving our competitiveness and build on our strong export performance.

Can we be optimistic about our economic prospects?

Yes, certainly. Our economy is emerging from recession:

- GDP will record a moderate increase this year on the back of strong export growth.
- Exports are expected to grow by about 6% in real terms this year, driven by improvements in competitiveness and a strengthening of international markets.
- Conditions in the labour market are beginning to stabilise.
- However, domestic demand remains weak as households and businesses continue to save at elevated rates and pay down debt.
- The current account of the balance of payments will record a small surplus in 2011, meaning that the economy as a whole is paying down external debt.

The conditions for sustainable export-led growth are in place:

- Good infrastructure.
- High-quality human capital.
- Tax policies which are favourable to entrepreneurship, investment and work.
- Adequate credit availability for viable businesses.

The Plan projects that real GDP will grow 2.75% on average over the 2011– 2014 period.

- 90,000 (net) new jobs will be created over the period 2012-2014.
- Unemployment will fall to below 10% by 2014.

How much more budgetary adjustment is needed?

- Adjustments of nearly €15 billion have already been implemented over the past two years. These measures have succeeded in stabilising the budget deficit.
- An additional €15 billion package of measures is required to bring the deficit back below 3% of GDP by 2014.
- This package will comprise $\frac{2}{3}$ expenditure and $\frac{1}{3}$ revenue measures.
- €6 billion will be front-loaded in 2011.
- Deficit will be reduced to 9.1% of GDP in 2011. Debt to GDP ratio will peak at 102% in 2013 and will fall to 100% by 2014.

Won't budget adjustments of this scale kill off any potential recovery?

No, the economy is projected to grow 2.75% on average over the 2011– 2014 period.

The adjustment will weigh on domestic demand, but its overall effect will be mitigated by:

- The economy's high propensity to import.
- Positive effect of budget adjustments on competitiveness and confidence.

What can the Government do to boost growth?

There are two pillars to the strategy for competitiveness, growth and employment:

- Remove potential structural impediments to competitiveness and employment creation.
- Pursue appropriate sectoral policies to encourage export growth and a recovery of domestic demand.

Specifically, the Government will:

- Reduce the minimum wage by €1 to €7.65.
 - High minimum wage is a barrier to job creation for younger and less skilled workers where unemployment rates are highest.
 - Will still be among the highest rates in the EU.
- Reform welfare system to incentivise work and eliminate unemployment traps.
- Re-invigorate activation policies to ensure that unemployed people can make a swift return to work.
- Promote rigorous competition in the professions and measures to reduce legal costs.
- Take decisive actions to reduce waste and energy costs faced by businesses.
- Enhance availability of technological infrastructure, in particular next generation broadband networks.
- Lead efforts to reduce office rents in both the private and public sectors.
- Increase efficiency in public administration to reduce the costs for the private sector.
- Implement sector specific measures to assist an increase in exports as well as an increase in domestic demand.
- Support innovation through the innovation fund and other enterprise supports and through our tax system.

Why must we reduce Expenditure?

- Significant increases in public expenditure during the boom.
- Ratio of day-to-day expenditure to GNP has jumped from 28% during the boom years to 44% in 2010 – this is unsustainable.

Current expenditure will be adjusted by €7 billion and capital expenditure by €3 billion.

Social welfare, pay and programme spending each account for around one third of total expenditure - reductions in each of these areas are unavoidable.

DOF07581-001

Government will:

- Reduce the cost of the public sector pay and pensions bill, social welfare, and public service programmes.
- Achieve savings in social welfare expenditure of €2.8 billion through a combination of control measures, labour activation, structural reforms, further reductions in rates as necessary and a fall in the Live Register.
- Cut public service staff numbers by 24,750 from end-2008 levels, back to levels last seen in 2005.
- Implement overall payroll adjustments of €1.2 billion by 2014.
- Introduce a reformed pension scheme for new entrants to the public service and reduce their pay by 10%.
- Make more effective use of staffing resources with redeployment of staff within and across sectors of the public service to meet priority needs.
- Reform work practices to provide more efficient public services with scarcer resources.
- Increase the student contribution to the costs of third level education.
- Introduce a charge for domestic water by 2014.
- Reform and update the existing budgetary architecture.

These reductions will bring expenditure back to its 2007/2008 level. Working age welfare rates will be reduced to slightly above 2007 levels.

Why do taxes have to rise?

Tax receipts in 2010 will be around 35% lower than in 2007, the steepness of the fall reflecting the over-dependence on property and construction-related revenue sources during the boom years.

Nearly half of income earners in 2010 will pay no income tax. This is not sustainable.

A fundamental principle of the reform outlined in this Plan is that all taxpayers must contribute according to their means. Those who can pay most will pay most but no group can be sheltered.

Is Ireland about to become a high-tax economy?

No, tax burdens are not going back to 1980s levels. The changes in the Plan will bring the income tax structure back to what existed in 2006.

What taxation measures will the Government introduce?

Government will:

- Maintain the 12½% corporation tax rate; this will not change.
- Raise an additional €1.9 billion through income tax changes.
- Implement pension-related tax changes to yield €700 million, with €240 million in tax savings on the public sector pension related deduction.
- Abolish/curtail a range of tax expenditures yielding €755 million.
- Increase the standard rate of VAT from 21% to 22% in 2013, with a further increase to 23% in 2014. These changes will yield €620 million.
- Introduce a local services contribution to fund essential locally-delivered services. This will yield €530 million.
- Increase the price of carbon gradually from €15 to €30, yielding €330 million.
- Reform capital acquisitions and capital gains tax to yield an additional €145 million.
- Transform BES into a new Business Investment Targeting Employment Scheme.

Why should we support this Plan?

Our economy will recover. Detailed policy measures identified in the Plan will build on our strengths and develop other sectors to provide a balanced economy and employment for our citizens. Our future prosperity rests upon the implementation of this Plan over the next four years.

DÁIL QUESTION

NO

To ask the Tánaiste and Minister for Finance if he will make a statement on the Exchequer returns for the first quarter of 2008; the estimated budget deficit he expects at the end of 2008; if he will compare this to the deficit forecast in Budget 2008; if he will provide revised Exchequer profiles for 2008 in view of his statement that shortfalls during the first quarter of the year are not expected to be recouped over the course of the remaining nine months of the year; and if he will make a statement on the matter.

- Joan Burton.

For PRIORITY answer on Thursday, 24th April, 2008.

Ref No: 15728/08

DÁIL QUESTION

NO

To ask the Tánaiste and Minister for Finance his views on the deteriorating condition of Ireland's public finances; and the underlying causes and the policy responses needed.

- Richard Bruton.

For PRIORITY answer on Thursday, 24th April, 2008.

Ref No: 15894/08

REPLY

Tánaiste and Minister for Finance (Mr Cowen) :

I propose to take questions and together.

At Budget time, an Exchequer deficit of €4,866 million was projected for this year. This was based on an economic growth rate of 3.0 per cent in GDP terms. However, a number of risks to the economic forecast were identified, including the possibility of a sharper slowdown in the US, the possibility of adverse exchange rate movements, the possibility that financial market difficulties could persist for longer than assumed and the possibility of a sharper contraction in new house building. It now appears that some of these risks have materialised and in this regard other economic commentators that produce forecasts on a more frequent basis have revised their forecasts for growth

in 2008 downwards. The market consensus is now for GDP growth of around $2\frac{1}{4}$ per cent this year, compared to a consensus of about $3\frac{1}{4}$ per cent at Budget time. More modest growth would, of course, have implications for the evolution of the public finances.

At the end of the first quarter, an Exchequer deficit of €354 million was recorded. Overall tax receipts were €600 million, or 5.1 per cent, behind target in the first three months of 2008. Over half of this shortfall was accounted for by the poor performance of Capital Gains Tax and the bulk of the remainder accounted for by weaker than anticipated VAT receipts. Most of the other taxes were closer to what had been anticipated. However, Income Tax was above target and this is a welcome indicator of the resilience of the Irish economy. At this stage it is not expected that this tax shortfall, particularly in CGT, will be recouped later in the year.

As regards expenditure, at end March total voted expenditure was broadly in line with target at €66 million or 0.6 per cent under profile. Voted current expenditure was 1.4 per cent below profile, while net voted capital expenditure was 4.3 per cent above profile. The strength of capital expenditure is due mainly to better than anticipated progress on a range of key capital spending projects. This is real evidence of this Government's commitment to continued investment in economic and social development.

While our fiscal position may have weakened from that envisaged at Budget time, it is important to point out that the current situation is manageable given the strong position of the public finances such as our low debt to GDP ratio. As is usual, my Department will continue to monitor and report regularly on progress compared to the published profiles issued at the end of January. Also, the fundamentals of the Irish economy remain strong. This will help us to absorb the housing adjustment and external 'shocks' so that our medium term prospects are favourable. For instance:

- our public finances are sound with one of the lowest levels of debt in the euro area;
- our markets are flexible allowing us to respond efficiently to adverse developments;
- we have a dynamic and well educated labour force;

- we have a pro-business outward looking society;
- the tax burden on both labour and capital is low.

I wish to stress that the Government accepts that there can be no unnecessary loosening of fiscal policy and, in that context, the implementation of the National Development Plan remains a key priority. As regards current day-to-day expenditure, it is crucial that the agreed budget spending limits are adhered to this year. As I indicated at Budget time, the rate of increase in current spending over the medium term must be managed carefully and kept within available resources. This Government intends to do just that.

Supplementary Material for PRIORITY PQs 15894/08 and 15728/08

PUBLIC FINANCES

Q. Is the Department going to have to revise its tax forecasts?

A. Taxes for the first quarter were €600 million or 5.1% below expectations and 6.2% down on Q1 2007. Roughly half of the shortfall on target was due to Capital Gains Tax and the bulk of CGT revenues are not due until November. At this stage, my Department does not expect that we will recover the tax shortfall at a later stage in the year. However, it is too early to draw any firm conclusions about the end of year outturn.

That said, the weaknesses in VAT and CGT are a concern and we will continue to monitor closely any emerging trends. Within this context, it is crucial that the significant Budget allocations for spending are adhered to.

Q. What is the likely end year tax shortfall?

A. Taxes for the first quarter were €600 million or 5.1% below expectations and 6.2% down on Q1 2007.

CGT is €311m below target, VAT is €253m below, Corporation Tax is €56 million behind profile, while Excises are €44m below target. However, income tax is €31m ahead of target.

Taken together, receipts from the “Big Four” taxes (Income Tax, VAT, Excises and CT) which accounted for about 88% of taxes collected in the first quarter are within 3.2% of target. [SEE TABLE AT TAB X].

Taxes were €35 million above target at the end of January, €552 million behind target in the month of February and €84 million behind target in the month of March. The relative recovery in receipts in March as compared to February, highlights the difficulty in drawing firm conclusions for the annual outturn at this stage. However, my Department will continue to monitor closely any emerging trends.

Q. What steps are being taken in light of the weak tax position?

A. At this stage of the year, it is too early to draw any definitive conclusions about the end of year outturn.

While some tax revenues have not performed as well as anticipated in the first quarter of the year, expenditure is generally in line with expectations. My Department will continue to monitor closely any emerging trends.

Within this context, it is crucial that the significant Budget allocations for spending are adhered to.

Q. What actions will the Minister take to secure the public finances?

A. First of all it must be remembered that we can meet the existing challenges because our fiscal position is strong –

- General Government Debt is forecast to be about 26% of GDP at end-2008, one of the lowest ratios in the euro area.
- Net Debt (i.e. debt net of the assets in the National Pension Reserve Fund) is forecast to be around 14% at end-2008.
- We are running a current budget surplus.

Secondly, a carefully considered and well targeted package was brought forward in Budget 2008 which will help buoy the economy during this difficult period. The purpose was to reward work while still protecting the most vulnerable in society.

The Government is committed to implementing the National Development Plan. This must be our priority as in doing so we will lay the foundations for future improvements in living standards. On that basis, it is prudent to borrow modestly so as to invest ambitiously thereby enhancing our productive capacity – capital spending will rise by around 12% this year.

I also indicated in the Budget that we must get back to lower single digit increases in current spending as quickly and as prudently as possible. A measured deceleration is

required, not a sudden slamming of brakes, especially in a period of below trend growth.

Q. Why hasn't the Minister used fiscal policy to stimulate the economy?

A. I took such action in my Budget in December. I injected a carefully considered and well targeted package which will help buoy the economy during this difficult period.

The Budget has moved from a projected surplus of 0.5 per cent of GDP in 2007 to a projected deficit of -0.9 per cent of GDP in 2008. Budget 2008 represents a significant stimulus to the economy made up of:

- approximately €1.7 billion on additional current spending, over half of which was for Social Welfare and related improvements;
- over €500 million on tax reductions; and
- over €1 billion on additional NDP capital spending.

My purpose in December's Budget was to reward work while still protecting the most vulnerable in our society. Alongside these aims, I also re-affirmed this Government's commitment to implementing the National Development Plan. On that basis, I indicated that it was prudent to provide for modest borrowings so as to invest ambitiously thereby enhancing our productive capacity – capital spending will rise by the order of around 12 per cent this year.

I also introduced fundamental reform of the Stamp Duty regime in relation to residential property in the Budget. This involved the abolition of the system which was based on six different thresholds and replacing it with a simplified system featuring two progressive rates. The purpose of this reform was to help restore confidence in the property market. Its timing ensured that the benefit accrues to purchasers rather than sellers who will already have benefited from a substantial capital gains tax exemption and it ended the speculation that had a damaging effect on the sector.

Key points from end-Q1 2008 Exchequer Returns

- **EBR Q1 2008:** deficit of €354 million (taxes €600 million or 5.1% below profile, spending €66 million or 0.6% below profile).
- **Budget 2008:** EBR of -€4,866 million in 2008;
- **Taxes:** -€600m or -5.1% **below profile** of which:

Customs	-€+6m	(+9.2%)
Excise	-€44m	(-3.1%)
CGT	-€311m	(-36.3%)
CAT	-€9m	(-10.1%)
Stamps	-€15m	(-2.8%)
IT	+€31m	(+1.0%)
CT	-€56m	(-6.3%)
VAT	-€253m	(-5.3%)
- **Y-on-Y Taxes at end-Q1:** -€739 million, Overall 2008 Target +3.5%,
- **Expenditure:** slightly below profile.

Overall: €11,142m or 0.6% below REV; Y-on-Y Q4 +13%

Current: €9,553m or 4.3% below profile; Y-on-Y Q4 +7%

Capital: €1,589m or 1.4% above profile; Y-on-Y Q4 +80%

Tax Receipts on a Monthly Basis – January to March 2008

Q1 2008	January €m	February €m	March €m	Q1 Total €m
VAT Receipts	2,335	364	1,828	4,527
Profile	2,400	510	1870	4780
+/-	-65	-146	-42	-253
Income Tax Receipts	1,208	1,037	873	3,118
Profile	1,154	1092	841	3,087
+/-	+54	-55	+32	+31
Corporation Tax Receipts	197	455	168	820
Profile	200	550	125	875
+/-	-3	-95	+43	-55
Excise Duty Receipts	472	451	436	1,359
Profile	465	450	488	1,402
+/-	+7	+1	-52	-44
CGT Receipts	129	387	31	547
Profile	137	650	70	857
+/-	-8	-263	-39	-310
Stamp Duty Receipts	180	192	158	530
Profile	175	195	175	545
+/-	+5	-3	-18	-15
CAT Receipts	27	35	21	83
Profile	26	28	38	92
+/-	+1	+7	-17	-9
Customs Duty Receipts	25	22	29	76
Profile	17	28	24	69
+/-	+8	-6	+5	+7
Overall Receipts	4,610	2,952	3,546	11,107
Overall Profile	4,575	3,504	3,630	11,707
Overall +/-	+35	-552	-84	-601

Any small discrepancies in overall totals are due to rounding of constituent items and non-inclusion of Unallocated Tax Deposits which stood at €49 million at end March.

HOUSING AND INDEBTEDNESS

Q. How has the deterioration in the housing market impacted on tax receipts?

Were you too dependent on property-related taxes?

A. We have not become overly reliant or dependent on revenue from this sector of the economy. The two taxes most closely related to property are Stamp Duty and Capital Gains Tax and taken together they accounted for around 13 per cent of total tax revenues in 2007. In contrast the four main tax-heads – VAT, Income Tax, Corporation Tax and excise duty – accounted for around 85 per cent of tax receipts.

In formulating budgetary policy, I would assure the Deputy that prudence and caution were exercised by not planning the public finances around the assumption that receipts from Stamp Duty and Capital Gains Tax would continue to grow as they had in the past.

In Budget 2008, I introduced a fundamental reform to the Stamp Duty regime in relation to residential property with the purpose of restoring confidence. The Budget forecast was for Stamp Duty receipts to decline by 10.4% in 2008 compared to 2007. At end-March Stamp Duty receipts were basically on target.

Capital Gains Tax has disappointed this year. At end-March, Capital Gains Tax was €311 million behind target. This shortfall reflects the more adverse conditions in equity and property markets. The next key payment date for CGT is at the end of October. At this stage it is not expected that this shortfall will be recouped later in year.

Q. What is the Tánaiste's reaction to the news that Ireland's private sector debt-to-income ratio is amongst the highest in the eurozone?

A. House mortgage finance represents approximately 85 percent of the outstanding stock of personal debt. Accordingly, a high proportion of private sector indebtedness in Ireland relates to borrowing for house-purchase which, in turn, involves the acquisition of an asset for the households. In the same way, borrowing by the business sector generally underpins investment, and the creation of business assets yielding future income. I fully support the vigilance of the Central Bank and the

Financial Regulator on the issue of personal credit and mortgage debt and in reminding both borrowers and lenders of the need for responsible behaviour.

Q. Has the Minister assessed the level of home repossession which are occurring; and if there are implications for public policy.

A. Reports relating to court proceedings for property repossession need to be interpreted with caution, given the variety of circumstances that give rise to such cases and the fact that not all of the proceedings relate to residential property. It should also be noted that even where such orders are secured some are not enforced. The number of orders granted by the High Court is a very small proportion — representing less than 0.3% in 2007— of the number of new mortgages issued in the same year. As such, care needs to be exercised in drawing any particular conclusions regarding the property market for public policy overall.

The Chief Executive Officer of the Financial Regulator, speaking to the 30 January 2008 meeting of the Oireachtas Joint Committee on Finance and the Public Service, pointed out that there are no indicators emerging as yet that there is a significant increase in default or arrears levels.

Q. Can you agree that housing is now the single biggest risk to the economy?

A. It is important to recognise that housing, while undoubtedly important, is just one of the challenges faced by the Irish economy. The main risk to the housing market stems from a shock to the wider economy. As a small and very open economy, Ireland is exposed to developments in the global economy. Global economic shocks are by their very nature difficult to identify or anticipate. Nevertheless, we can identify some specific global risks which could impact on the Irish economy and feed through into the housing market. These risks include a deepening and widening of the turbulence in financial markets leading to slowdown in world economic growth.

There are also internal risks to the economy's future performance. The most notable risk is the potential for a sharp loss in cost competitiveness and a decline in the attractiveness of Ireland as a location for mobile foreign direct investment. Maintaining and improving our international cost competitiveness highlights the

importance of social partnership in helping to ensure sustainable economic development.

Q. Should the Tánaiste not have taken a more active role in curbing rising debt levels?

A: I have frequently commented in the past that I fully support the vigilance of the Central Bank and the Financial Regulator on the issue of personal credit and mortgage debt and have reminded both borrowers and lenders of the need for responsible behaviour. I have also drawn attention to the fact the Central Bank has highlighted the need for borrowers and lenders to factor into their financial decision making the prospective impact of potential changes.

Q. Are house prices now not substantially out of line with their real value?

A. As I have said on a number of previous occasions, the increase in house prices since the mid-1990s must be seen in the context of considerable structural change and advances in our economy since then. For instance:

- employment has risen by 50 per cent since the mid-1990s
- wages per capita have also risen significantly over this period, and this has been supplemented by a reduction in the burden of income taxation
- demographic factors – such as immigration and the increase in the number of people in the 25- 35 year old age cohort – have also been an important source of housing demand
- the role of lower interest rates from our participation in EMU has also been important; for instance real interest rates – that is, mortgage rates adjusted for the impact of inflation – have been close to zero since 2000 compared to typical real rates of around 7 per cent in the early 1990s.
- financial market liberalisation, competition and innovation have also played a role by improving access to credit.

My view is that these fundamental factors largely account for the increase in prices since the mid-1990s.

Q. Ireland's economic growth is now unbalanced given the disproportionate importance of construction. What is your view on this?

A. I have been consistent in my articulation of the potential risks to Ireland's economic wellbeing. One thing that is certain is that the international economic climate is unpredictable and subject to rapid changes. This can have profound implications for a small and open economy such as ours. Closer to home there are also some important risks to Ireland's economic performance, including those that the very strength of the housing market brings with it.

Investment in construction has been driven by strong activity in the residential, commercial and infrastructural sectors. The residential sector has been particularly strong, with the high demand for housing being underpinned by strong economic fundamentals and a rapidly growing population. An easing back of housing output is now taking place with output levelling off at more sustainable long-term levels. Our commitment to the NDP at 5.4% of GNP, will inter alia, ensure that spare capacity from one sector is available in the other commercial and infrastructural sectors.

Q. When will the housing market decline start to ease off?

A. There is great difficulty in precisely estimating this. It must be borne in mind that the underlying demand for housing is strong as evidenced by the strong growth in rents and supported by continuing high employment and migratory inflows. The OECD note in their economic survey of Ireland, that in line with international experience of housing construction cycles, a correction is usually short-lived with sharp falls in the first two years. As such, it is anticipated that barring further shocks to the international economy, the downswing in activity could soon be over and that house-building would return to the rate needed to meet the growing demand for housing. The level of sustainable housing output will be below the levels achieved in 2006 and 2007, but still more in line with stable market conditions of around 60,000 units per annum. The Permanent TSB/ESRI House Price Index has exhibited a more gradual pace of decline in recent months which may be a tentative indicator that the market is stabilising.

Q: Will the tightening of availability and costs of mortgages not contribute to further dampening down of demand?

A. Information emanating from the banking sector suggests that the global credit squeeze has impacted in Ireland in recent weeks, with banks withdrawing some mortgage products, increasing their mortgage rates to new customers and more generally tightening their lending practices to both commercial and personal customers. Of course at the margins this will have some effect but latest data from the Central Bank indicate that mortgage growth is still fairly robust at 12.3% year-on-year in February, and I would not envisage the more prudent conditions being attached to mortgages as having a major effect on housing demand over the medium term.

Q. Is the international financial crisis threatening the Irish banking system?

A. The Irish financial system has been positively assessed by the Central Bank and Financial Services Authority of Ireland in its Financial Stability Report and more recently by the OECD. The OECD's Economic Survey of Ireland, 2008 points out that Irish banks entered the current period of international financial turmoil in a very strong position and that they, therefore, have considerable capacity to respond to unexpected developments. The OECD noted that sustained economic growth has ensured that Irish banks are well positioned to deal with recent market developments. The OECD welcomed the findings that Irish banks have little exposure to the sub-prime market, hedge funds and the private equity sector.

I would remind Deputies that the most important safeguard of financial stability is the existence and effective operation of the financial regulatory and supervisory regime. In Ireland the Central Bank and Financial Services Authority of Ireland integrates within a single institutional structure both the supervision of individual financial firms by the Financial Regulator and the monitoring of overall financial stability, which is the independent responsibility of the Governor of the Central Bank. The roles are complementary and this structure yields significant advantages in terms of monitoring and maintaining financial stability in ensuring seamless, effective and timely co-ordination of these two key functions. It is important to emphasise that the framework for financial regulation here is shaped by a detailed and comprehensive template which applies across the EU and that our approach has been positively assessed by both the IMF and OECD.

DÁIL QUESTION

NO

To ask the Minister for Finance the expected tax revenue outturn and Exchequer borrowing requirement for 2008; his views on the November 2008 Exchequer returns and live register figures and their implications for the modification of his Budget 2009 forecasts for 2009 tax revenue and average unemployment; his strategy to address Ireland's economic difficulties and get people back to work; and if he will make a statement on the matter.

- Joan Burton.

For PRIORITY answer on Thursday, 11th December, 2008.

Ref No: 45389/08

DÁIL QUESTION

NO

To ask the Minister for Finance if he has assessed the extent of the expected shortfall in tax revenue in 2009 and the additional cuts in current spending which he is targeting.

- Richard Bruton.

For PRIORITY answer on Thursday, 11th December, 2008.

Ref No: 45545/08

REPLY

Minister for Finance (Mr Lenihan):

I propose to take questions number and together.

In the period since the Budget was presented to this House, the economic environment has become considerably more difficult. Many of our trading partners have entered recession and projections for demand in our key export markets have been revised downwards significantly. To put this into perspective, the IMF now expects economic activity in the world's advanced economies to contract next year, the first contraction for this group of countries in the post-war period. On the domestic front, the economic and fiscal data which have become available since the Budget have been poor, confirming that the outlook for next year has deteriorated further.

The November Exchequer Returns show that overall government spending for 2008 is close to what was planned. However, the latest 2008 tax returns reflect the severity of the current economic slowdown which has accelerated considerably both at home and internationally in recent times. The gap between spending levels and tax receipts in 2008 has widened and as a result I now expect that the Exchequer will have to borrow about €13 billion in 2008.

In the Budget my Department projected that the economy would contract by 1 per cent in 2009. Forecasts produced by the ESRI and by the Central Bank set out a similar economic assessment. Reflecting the unprecedented recent economic developments since then, by end-November the consensus of market forecasters was for economic activity to decline in 2009 by around 3 per cent.

At Budget time, I identified that there were significant risks to the economic and fiscal forecasts for 2008 and for 2009. The further deterioration in tax receipts in 2008, as seen by the end-November Exchequer Returns, the continuing weakening of consumer and investor confidence, adverse currency movements, continued difficulty in the international financial markets and depressed economic conditions, are all evidence of those risks materialising. All indications are that economic activity in 2009 will contract by significantly more than the forecast in the recent Budget with an overall contraction of perhaps somewhere in the region of 3 to 4 per cent. The disimprovement in the 2008 revenue take alone would push the 2009 General Government Deficit up by about €1.5 billion to 7½ per cent of GDP. In addition, each 1 per cent disimprovement in economic activity in 2009 beyond the contraction of growth of 1 per cent already forecast would increase the General Government Deficit by about ½ per cent.

Upon receipt of the end-year fiscal data and the latest economic data, including the third quarter national income data, a revised economic and fiscal assessment will be prepared by my Department in early January and brought forward for Government consideration. This assessment will reflect the dramatically changed environment now being faced. We are living in a time of unprecedented economic difficulties, and the changed circumstances that have occurred in a short period of time must be addressed.

In terms of Government action, I would remind the Deputy that last summer in response to the weakness in tax receipts, we took steps in relation to the growth in public expenditure. Then in the autumn we decided to bring forward the Budget so as to address the fiscal situation. In the Budget we took various measures needed to safeguard the public finances as well as underpinning economic activity. For instance we are continuing to invest about 5% of GNP in capital projects that will enhance the productive capacity of the economy. Also the Finance Bill has a number of pro-enterprise measures including various improvements to the Research & Development tax scheme.

Now, in the light of the further deterioration in the economic and budgetary situation, the Government is continuing to identify measures to ensure the sustainability of the public finances, while also focusing on areas that can expand the productive capacity of the economy. This will enable the economy to be suitably positioned to exploit the global recovery when it emerges either late in 2009 or, as is now more likely, well into 2010.

The strategy for addressing the economic difficulties will be based on a number of inter-related areas –

- Firstly, the public finances must be restored to a sustainable position and a key milestone in this process is the restoration of the Current Budget to a balanced position as soon as possible. Given that a very high level of borrowing was already planned for 2009, the main focus must now be on the very significant amount of money the Government is spending on current services. In this regard the work of the Special Group on Public Service Numbers and Expenditure Programmes will have a significant role to play.
- We will continue to prioritise our current level of spending on public investment, which at some 5 per cent of GNP, is amongst the highest levels of capital commitment in the EU.
- Thirdly, we must ensure that Ireland is competitive to ensure that the economy is in a position to take advantage of the global recovery when it emerges. Wage levels in the public and private sector will be key to this task.

- Fourthly, we will continue to invest in education and training to equip the labour force with the necessary skills.
- Fifthly, we will continue to identify all possible measures to boost the productive capacity of the economy.
- Finally, as evidenced in our recent Budget, the Government will continue to support the less well-off through our welfare and income policies.

Supplementary Questions

Tab 1 - The Budget and Revision to Forecasts

Key Points –

- Dept Finance revising economic and fiscal forecasts in light of end-year data.
- 2009 growth likely to contract somewhere in the region of 3-4%.
- Remedial steps to deal with deterioration in the public finances will focus on reducing spending. The work of the Special Group on Public Service Numbers and Expenditure Programmes will have a significant role to play in this regard.
- The new pay agreement includes a pay pause for the public service for 11 months. Therefore an increase for public servants does not arise at this stage. However, continuing to keep all elements of public expenditure under review.

Tab 2 - The Public Finances and Tax Revenues

Key Point –

- Taxes €7.4 billion behind target at end-November, €8 billion shortfall likely for year. Budget 2009 forecast €6½ billion shortfall.
- 2009 already €1½ billion worse, implying a GGB of -7¼% of GDP solely as a result of the likely 2008 tax shortfall.

Tab 3 - Fiscal Stimulus Package

Key Points –

- Priority is to restore public finances to sustainable position of funding day-to-day spending from current resources.
- Maintaining capital spend on productive investment.
- Must ensure Ireland regains competitiveness.

Tab 4 – The Economy

Key Points –

- Budget forecasts were in line with consensus. Since then significant deterioration in outlook, with many forecasters national and international revising their numbers
- Unemployment has increased – focus must be on ensuring those losing their jobs have the necessary training to find alternative employment.

Tab 5 - Special Group on Public Service Numbers and Expenditure

Key Points –

- Has begun its work and will report every two months with updates.
- Will identify options for savings in context of Government's fiscal objectives.
- Will ensure public expenditure is used to address relevant priority objectives.
- Overall efficiency of the public service will also be examined.

TABLE 10: Personal Disposable Income

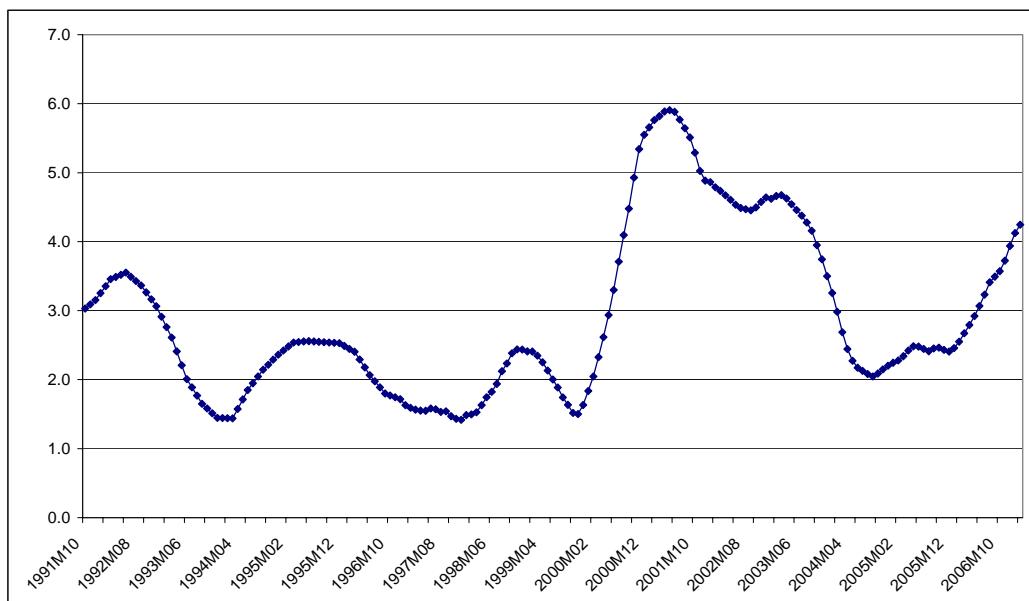
	2005 €m	%	Change €m	2006 €m	%	Change €m	2007 €m	%	Change €m	2008 €m
Agriculture, etc.	3,399	5.0	170	3,569	4.0	143	3,712	4.0	148	3,860
Non-Agricultural Wages	65,272	10.1	6,605	71,877	10.2	7,314	79,190	6.4	5,079	84,269
Other Non-Agricultural Income	16,956	2.8	473	17,428	10.0	1,750	19,178	6.5	1,252	20,430
Total Income Received	85,627	8.5	7,248	92,874	9.9	9,206	102,080	6.3	6,479	108,560
Current Transfers	17,633	6.7	1,190	18,823	15.3	2,871	21,694	6.2	1,354	23,047
Gross Personal Income	103,260	8.2	8,437	111,697	10.8	12,077	123,774	6.3	7,833	131,607
Direct Personal Taxes	19,578	9.0	1,758	21,336	10.2	2,179	23,515	5.6	1,328	24,843
Personal Disposable Income	83,682	8.0	6,679	90,361	11.0	9,897	100,259	6.5	6,506	106,764
Consumption	74,114	10.0	7,414	81,528	11.5	9,393	90,922	6.6	5,992	96,913
Personal Savings	9,568	-7.7	-735	8,833	5.7	504	9,337	5.5	514	9,851
Savings Ratio				9.8			9.3			9.2
Average Personal Tax Rate	19.0			19.1			19.0			18.9

Consumer Prices

According to the Consumer Price Index (CPI), the annual rate of inflation registered in February was 4.8 per cent, down from 5.2 per cent in January and 4.9 per cent in December. Despite the slight slowdown in the annual rate, inflation has been high and above 2 per cent since the end of 2004, and in recent months has reached five-year highs; the January rate was the highest registered since the middle of 2001.

Figure 8 shows the twelve-month moving average rate of inflation since 1991. Following a spike of almost 6 per cent in 2001, inflation moderated to reach a low of 2 per cent in September 2004. However, since then inflation has moved upwards and the average of the twelve months to February 2007 reached 4.2 per cent, suggesting surging price pressures in the economy.

Figure 8: Rolling Twelve-Month Average Inflation Rate



The rate of inflation in February was driven mainly by external forces, though domestic price pressures also added an upward stimulus to the index. Of the twelve aggregate categories covered by the CPI⁶, the three largest contributors, with the percentage of the total inflation rate in February accounted for by these categories given in parenthesis, were:

Housing, Water, Electricity, Gas and Other Fuels (77.7 per cent)

Hotels and Restaurants (13.7 per cent)

Alcoholic Beverages and Tobacco (6.9 per cent)

⁶ The twelve categories covered by the index are: Food and Non-Alcoholic Beverages; Alcoholic Beverages and Tobacco; Clothing and Footwear; Housing, Water, Electricity, Gas and Other Fuels; Furnishings, Household Equipment and Routine Household Maintenance; Health; Transport; Communications; Recreation and Culture; Education; Restaurants and Hotels; Miscellaneous Goods and Services.

The “Housing, Water, Electricity, Gas and Other Fuels” category includes items like *Rents, Mortgage Interest, Maintenance and Repairs, Electricity, Gas and Other Fuels*. The most important of these components for the “Housing, Water, Electricity, Gas and Other Fuels” category’s contribution to total inflation in February was the *Mortgage Interest* component. This component has driven price increases in the “Housing, Water, Electricity, Gas and Other Fuels” category since the end of 2004.

The “Housing, Water, Electricity, Gas and Other Fuels” category has the largest weight in the CPI, reflecting the importance of expenditure under this heading for the average consumer. In fact, expenditure under this heading represents 16.5 per cent of the average consumer’s total spend. This weighting increased from 12.3 per cent in December 2001.

The “Hotels and Restaurants” category registered an increase as a result of price rises in both catering services and accommodation services. Catering services recorded a 3.6 per cent price hike in January 2007 relative to January 2006 while Accommodation service prices registered 9 per cent growth. Under the “Alcoholic Beverages and Tobacco” category, alcoholic beverages actually registered a price decline in the year to February, but this fall was offset by an increase of over 10 per cent in the price of tobacco.

The outlook for 2007 is for a higher rate of inflation than 2006. Over the coming months, we expect annual inflation to come down from the peak registered at the start of the year, though nonetheless remaining high. The annual average rate of inflation for the year is forecast at 4.6 per cent. This is significantly higher than the 3.9 per cent figure forecast in the previous *Commentary*. The main reason for the higher forecast is that we now expect a second interest rate rise in 2007, as discussed in the *International* section.

In 2008, we forecast a rate of inflation of 2.6 per cent. The slowdown in inflation in 2008 is likely on the assumption that there are no further interest rate increases in that year, and the slow down in consumption growth will ease some inflationary pressures.

Inflation as measured by the Harmonised Index of Consumer Prices (HICP) was 2.6 per cent in February. This compares to a rate of 2.7 per cent in the same period of 2006 and ranks Ireland with the second highest inflation rate in the Euro Area.

Table 11: Inflation Measures*

	2000	2001	2002	2003	2004	2005	2006	2007	2008
	%	%	%	%	%	%	%	%	%
HICP	5.2	4.0	4.7	4.0	2.3	2.2	2.7	2.5	2.2
CPI	5.6	4.9	4.6	3.5	2.2	2.5	4.0	4.6	2.6
Mortgage Interest	12.5	24.7	-7.6	-8.3	5.4	12.3	31.5	39.1	5.4

*Based on December 2006 weights.

General Assessment

The latest economic indicators suggest that 2006 was a year of exceptionally strong growth in both output and employment, with GNP growth estimated at 6.3 per cent and total employment increasing to over 2 million. Growth in 2006 was dominated by increases in consumer expenditure and investment spending. In 2007 we expect the pace of consumer expenditure growth to accelerate further to 7.8 per cent, driven by the maturing of SSIA, while the pace of investment growth is projected to moderate, with housing investment expected to level off. The prospects for 2008 point to a slowdown in GNP growth to below 4 per cent, as consumption expenditure growth reverts to more normal rates and the pace of investment expansion continues to slow.

These figures sketch a picture of continued strong growth in output and employment in 2008, albeit at a significantly slower pace than in the years 2005 to 2007. We believe that the recent growth performance of the economy raises a number of serious concerns about the sustainability of the current growth trajectory. As discussed in previous *Commentaries*, growth in the past three years has been entirely domestically generated and is likely to remain so in 2007 and 2008 (see Figure 5 above). Since 2004, Ireland's net export performance has ceased to be a driver of growth. Instead the current boom has been entirely driven by domestic demand, which we believe is unsustainable in the medium term. In this *General Assessment* we have chosen to focus on three areas of concern within the domestic economy: the growing balance of payments deficit, the size of house building in the context of the overall economy, and wage determination.

As discussed in previous *Commentaries* the current account of the balance of payments has widened rapidly since 2003 and is forecast to continue to widen out to 2008. Taking a look at this from the perspective of financial flows produces some interesting insights. The corollary of the widening current account deficit has been an increase in net investment inflows into Ireland through the financial account of the balance of payments. These inflows have been used to fund the growth in investment's share in GDP since 2003. Table 12 illustrates the point. Gross investment as a share of GDP has risen from 24 per cent in 2003 to an estimated 28 per cent in 2006. Over this period net national savings and depreciation have remained broadly stable so that this increase in investment has largely been funded by the increase in the item termed "net foreign disinvestment", which is net foreign investment inflows through the capital and financial accounts of the balance of payments.

In the December *Quarterly Economic Commentary* we discussed the implications of the rapid widening in the current account deficit, in particular as a symptom of imbalances emerging elsewhere in the economy. The factors underlying the deficit are critical in assessing implications. The crucial issues that determine possible impacts are whether the deficit can be regarded as the consequence of rapid investment to fund Ireland's broad infrastructural deficit – compatible with a sustainable growth trajectory – or whether it is

Note for the Minister's Information on financial market

developments for Government meeting of 3 September 2008

Overview

International Situation

- Financial market conditions remain exceptionally difficult and the international financial sector remains under considerable stress with credit availability restricted, the cost of funds elevated and no near term 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 a tightening of the availability of liquidity from the ECB and the prospect of major international banks having to roll-over an estimated \$800 million [billion] 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 new valuation approaches) have yet to be finalised and will in any event take some time to bear fruit.

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 provides some scope to deal with the current financial market environment. As the economy slows bad debts are expected to increase and this will impact on profitability. However, domestic retail banks
- 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 no direct exposure to US sub-prime lending, Ireland cannot hope to completely escape the impact of international developments and in particular the effective closure of the main markets for long term debt. The tightening and increased cost of credit, which has coincided with a significant correction in construction activity, has thrown into sharp relief the reliance of domestic retail banks on wholesale financial markets to finance mortgage and property lending. [this sentence could mislead as even banks with lower level of wholesale funding have been materially impacted. It is also important to note that the wholesale market is comprised of a number of different markets e.g. securitisation, bonds, interbank etc. All have been affected and this has had an impact even for

institutions that were well diversified. Further, both wholesale and retail financing have become more expensive as liquidity has tightened and greater competition in the retail market is creating challenges]

- 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 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 that the financial system cannot 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.

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. 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.

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 [Financial Regulator] 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.

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 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

¹ Federal Home Loan Mortgage Association (Fannie Mac) 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 lead 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.
- **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 ½ 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 levels of 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 radically altered their loan product line and require increased equity input from prospective borrowers.

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. [This figure fluctuates and it may be too strong to suggest that there is a downward trend]

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

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

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

A. Why was there a need for Government Intervention?

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

B. What Action has the Government Taken?

Bank Guarantee Scheme

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

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

Recapitalisation

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

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

Protecting Taxpayers

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

Ensuring Credit Availability and Helping Bank Customers

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

Business Lending

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

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

Mortgage Lending

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

Remuneration

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

Co-Ordination at EU level

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

D Anglo Irish Bank

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

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

E Next Steps

Banking Regulation

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

Dealing with Impaired Assets

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

Minister from D. Doyle

Supplementary Budget

1. As you know I have been very concerned for some time about the financial markets and their relationship with Government funding and flows to the banking sector. I gave you a note about this on 21 January (copy attached). Since then over €50 billion has left the country.
2. It is essential that the Government, on 7 April, have a credible and marketable fiscal adjustment plan. This needs to
 - have a clear downward trajectory for the Government deficit
 - have detailed spending and tax measures identified for 2009, 2010 and 2011 with a framework for 2012/3.
3. I suggest that the Government tonight adopt the trajectory that it wants to achieve for the Deficit for the next five years.
 - (i) The nominal GGD trajectory in the absence of policy change is now likely to be:

	2009	2010	2011	2012	2013
GGB	-12 ³ / ₄ to	-17 ¹ / ₂ %	-17%	-17 ¹ / ₄ %	-16%
% of GDP	-13%				

- (ii) The savings requested for a possible defensible deficit trajectory would be as laid out in option 3 of the attached note. This requires a saving of €5 billion this year and an additional €4 billion in each of the years out to 2013. If this is achieved then the likely deficit trajectory will achieve the 3% target by 2013 and would be roughly of the following order in each of the years:

	2009	2010	2011	2012	2013
GGB	-10 ¹ / ₂ %	-11%	-8%	-5 ³ / ₄ %	-3%
% of GDP					

4. I would also suggest that the Government move tonight towards identifying the measures it is willing to adopt. We can then reflect on what the impact of these measures on getting to the approved trajectory might be and can update you and the Taoiseach tomorrow.
5. Notes attached set out taxation and expenditure measures for consideration.
6. Finally, on a practical note, the Government would need to identify the bulk of measures by Sunday next with final decision by Tuesday next so that the Budget can be produced on target.

24 March 2009

Meeting of 26 September 2008

Merrill Lynch presented a number of options – see document of 26 September 2008

Attendance:

ML X3 = Prasath, Baldock, Andreas Orcelli
Bob O'Hara
Con Horan
K Cardiff
D Doyle
Minister

ML points

- Worst credit crisis ever
- Need break a bad cycle
- French Government has indicated it will guarantee deposits
- However, number of situations where blanket guarantee may not add up having regard to numbers
- Liquidity is moving very very quickly
- Ireland is not an isolated case – other Governments also seeking ML advice, for example
- Management teams tend to try to play out to the end, because Government intervention tends to change the team, the advisers etc – their incentive therefore is to be over optimistic
- But it can create difficulties to go in without being asked in.

Presented a central scenario as follows

(a) provide liquidity on 'penal' terms – must not be easy money
(b) intervention

Difficulties – scale of intervention required.

Dangers with blanket guarantee – credibility and prolonging of weak institutions

Question of who should be protected in interventions – at least depositors in serious debt – possibly dated subordinated debt.

Big question is how to navigate between intervening early to protect deposits and minimise costs and giving time to markets and management to realise there is a problem and adjust to that reality (can happen in days). But corporate deposits can exit very quickly in the meantime.

On a blanket guarantee for all banks – ML felt could be a mistake and hit national rating and allow poorer banks to continue.

Liquidation – ML said this was the worst thing that could be done – accelerating trouble for all other institutions.

More generally, institutions should be encouraged to sell assets and get equity.

Next week is likely to be a very bad one in markets: Fortis, B&B, Dexia all having difficulties – EU will have to look at some more generalised action.

Minister asked that the options be articulated clearly over weekend so as to be ready to present to Government.

The Minister left and there was a discussion on allocation of work. To recommence at NTMA Sunday morning.

Different needs

The issues and options outlined at the previous meeting were presented by NC who understood the urgency of the situation. It was agreed that more work continue on the substantive possibilities outlined, and on preparing the relevant legislation.

Minutes of 26/9/08

Morti'll Lynch presented a series of options - See minutes of 26/9/08

Attendees:
NC x8 = Prout, Biddoch, Adams, O'Brien
Bob Quinn
Ciaran Horan
Kieran O'Brien
D. Doyle
Minutes

AC Update - worst credit crisis ever

- need to break a bad cycle
- Fraud has led individuals to withdraw deposits
- however, no. of situations where blanket guarantee may not add any benefit regard to numbers
- liquidity is moving very very quickly
- Ireland is not an isolated case - other countries also seeing the same, for example
- Management teams tend to try to play out to the end, because bank intervention tends to change the team, the advisory etc.
- this indicates therefore is to be more optimistic
- but it can create difficulties to go in without being asked in

Proposed a central scenario is as follows

- a) provide liquidity, a 'good' team - must not be cosy manager
- b) intervention

difficulties - such of intervention required

days with blanket guarantee - credibility and perception of weak institutions

question of who should be protected in repossession

- at least depositors + senior debt

- possibly, dated subordinated debt.

Big question is how to reconcile between repossession early to protect depositors + minimize costs and giving time for markets and consumers to settle. There is a problem and adjust to that reality (can happen in days). But corporate depositors can exist very quickly: the machine

On a global standard for all banks - the fact could be a mistake - and hit rating rating + other form banks to continue. Non-bank institutions

Liquidity - Mo said this was the worst thing the central bank - accepted
trouble for all other institutions

Non-bank, institutions should be encouraged to sell assets + get equity

Next week is likely to be a very bad one: markets + banks, BIS, ECB
Deny all bank deposits - EU will have to take some prudential action.

Minister asked that the option be articulated clearly ^{and assert} so as to be ready
to present to government

The Minister left and there was a discussion on amount of money

To recover @ NAMA Sunday morning

Memo : Sent to Minister 30 Aug
Discussed between Minister & Taoiseach 30 Aug
Considered by MFC 1 Sept.

F43/1/08

3 September 2008

Office of the Minister for Finance

SECRET

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**Update on the Emerging Economic and Fiscal Position
2008-2011**

DECISION SOUGHT

1. The Minister for Finance requests the Government to:
 - (i) note that the economic slowdown has continued and become more pronounced over the summer;
 - (ii) agree that the current state of the public finances and its future trajectory if left unchecked is untenable;
 - (iii) agree that it is essential that necessary action, in addition to all that was agreed by the Government in July, is now urgently required; and
 - (iv) to work on the plan of actions as set out below.

INTRODUCTION

2. The Government in July adopted measures to make savings of €440 million in 2008 and €1 billion in 2009. This was on the assumption of a shortfall of €3 billion in tax revenue for this year and GDP growth of 1½% for 2008 with growth averaging 3½% over the 2009-2011 period.
3. Since then the overall picture has deteriorated -
 - tax revenue in both July and August showed significant weakness;
 - all economic data, such as retail sales, labour market figures, housing starts, confidence data etc, show the economy is slowing. The prospect for 2009-2011 is now considerably weaker;
 - further spending pressures have emerged despite the Government decision in July to make adjustments of €440 million in 2008; and
 - it is now certain that the end-year tax shortfall will be substantially higher than previously expected. The Department of Finance is currently factoring in a shortfall of €5 billion in tax receipts for the year as a whole and it could be higher.

OUTLOOK FOR 2008

The Economy

4. A revised GDP forecast of 0.5% for this year was published alongside the half-yearly Exchequer figures in July. In broad terms economic activity is now at a standstill and may well be actually contracting. The only area that is likely to show growth is the external high-tech sector and while this is welcome this will

not compensate for the shortfall in taxes and employment that is materialising as the property market adjusts to a more sustainable level.

Tax Revenue - 2008

5. Over the summer months tax revenue has continued to disimprove and by end-August a tax shortfall of almost [€3] billion has materialised. There are significant and growing tax targets for the coming months with November being a key payment date for Corporation Tax, Capital Gains Tax and self-employed Income Tax. As a result the Department of Finance is currently factoring in a shortfall of €5 billion in tax receipts for the year as a whole.
6. This projected tax shortfall of €5 billion may not be enough and will be reviewed in the light of the September data and it is far from certain that this current working estimate is sufficient. The Department of Finance will, as is customary, publish its latest tax call at the end-third quarter Exchequer press conference.

Expenditure - 2008

7. Pressures of over €1 billion have been signalled to the Department during the summer. When account is taken of the Government decision to make adjustments of €440 million the underlying spending pressures amount to almost €680 million. The vast majority of this potential expenditure overrun relates to welfare payments and spending pressures in the health area. In addition in the agricultural area there is a potential significant overrun on the capital side.

Overall Budgetary Position - 2008

8. The table below sets out the position in June and the current working assessment.

Table 1: Main Budgetary and Fiscal Aggregates 2008

2008	June	Now
GDP (%)	1.3%	½%
Current Expenditure y-on-y %	€52.8 billion 8.2%	€53½ billion 9½ %
Tax Revenue y-on-y %	€45.9 billion -2.8%	€44 billion -7%
Current Bal.	+ €1.9 billion	-€350 million
Exchequer Bal.	- €7.7 billion	-€10 billion
GGB (% of GDP)	-2.7%	-4½%

9. In June the Minister indicated that based on the position as it then stood, a General Government Deficit of around 2½% of GDP was likely. Taking the further developments on taxation and expenditure as outlined above into account, a General Government Deficit of at least 4½% of GDP now seems likely for this year. If either tax revenue weakens further or additional spending pressures are identified then this very weak position will worsen.

OUTLOOK FOR 2009-2011

10. The table sets out the current working forecasts

Table 2: Macro-economic forecasts 2008 – 2011 (% change)

	2008	2009	2010	2011
GDP	½%	1%	3%	3¾%
GNP	½%	¾ %	2½%	3½%
CPI inflation	4½%	3%	2½%	2¼%
HICP inflation	3¼%	2 ½%	2¼%	2%
Employment growth	9,000	-8,000	10,000	24,000
Employment	½%	-½%	½%	1¼%
Unemployment	5½%	6¾%	6½%	6%

11. The Department of Finance is currently working on the economic growth and fiscal forecasts for the period 2009-2011 and will be firming up on its assessment during the month of September as more economic and fiscal data becomes available. These forecasts are normally published in the Pre-Budget Outlook in October which then forms the basis of the opening position for the Budget.

The Economy

12. In terms of 2009, the indications are that the pace of economic growth will be about 1%. As a result of this significantly below potential growth it is very likely that there will be significant further increases in unemployment. This expected weak growth will have negative implications for the public finances, on both the revenue and expenditure sides.

13. When last presenting to Government, it was hoped that the economy would return to its trend rate of growth - which is estimated to be nearly 4% per annum - by 2010. At this stage, this is becoming increasingly unlikely and it now appears that it will be 2011 before the economy returns to potential. Even this is contingent upon restoring international confidence in the Irish economy (through for instance prudent management of the public finances) and on implementing measures to restore our cost competitiveness.

Tax Revenue

14. The poor tax performance in 2008 feeds into the base and this coupled with lower economic growth means that the projected receipts for future years are much lower than was previously forecast. The current working assumption is that after a decline of 7% in tax revenue this year, the best that can be hoped for in terms of tax revenue is that 2009 will equal 2008. This means that tax revenue for 2009 is now forecast to be almost €8 billion lower compared with the view at last Budget. This has obvious implications in terms of the scope that the Government has in relation to future Budget policy.

Expenditure

15. The latest Department of Finance estimates provide for current expenditure to expand by 3½% next year which is considerably lower than the outcome in recent years. This is based on the assumption that the almost €1 billion savings identified for 2009 and agreed by Government last July are delivered in full. The 2009 estimate does not allow for any service improvements.

Overall Budgetary Position likely to emerge without corrective action

16. When the above tax revenue and expenditure factors are taken account of the overall Budgetary position points to a General Government Deficit of around 5¼% of GDP in 2009 and remaining at this level in the subsequent two years on the assumption that is no change in policy. As the Exchequer moves further into deficit there is a real likelihood that by 2011 the debt will have more than doubled in nominal terms from the end 2007 level. On this basis the public finances would be in an unsustainable and untenable position and the Minister for Finance will not accept this.

17.

Table 3 – Key Economic and Fiscal Aggregates 2008-2011

	2008	2009	2010	2011
GDP (%)	½%	1%	3%	3¾%
Expenditure y-on-y %	€53½ billion 9½ %	€55½ billion 3½%	€56½ billion 2¼%	€58½ billion 3 ½ %
Tax Revenue y-on-y %	€44 billion -7%	€44 billion 0%	€45¾ billion 4½%	€48¾ billion 6½%
Current Bal.	-€350 million	-€3 billion	-€2¾ billion	-€1¾ billion
Exchequer Bal.	-€10 billion	-€12¾ billion	-€13½ billion	-€13½ billion
GGB (% of GDP)	-4½%	-5¼ %	-5½%	-5¾%

18. As outlined previously, allowing the Budget position to drift has serious implications such as:

- loss of domestic confidence;
- loss of international confidence in the Irish economy;
- increased costs of money supply to Irish companies and borrowers generally, including the cost of Public Service borrowing;
- a build up of problems which by 2011-2012 would lead to very significant enforced and widespread cuts in public services; and
- very significant tax increases to bring the budget path down to a sustainable level.

19. This has long-term implications for Ireland's economy. In addition, allowing the General Government Balance to deteriorate in this manner would have significant implications for Ireland's reputation. While it is fair to say that other EU and in particular euro area countries have breached the 3% limit in the past and some are likely to do so in the immediate future, the significant deterioration in Ireland's case from surpluses in recent years to such a large deficit will attract very substantial negative attention. Furthermore, the possibility that Brussels would make recommendations in advance of Budget 2009 designed to ensure that the fiscal is immediately reversed cannot be ruled out. The Minister will update his European colleagues in October.

Actions now urgently needed

20. The measures agreed in July are now wholly inadequate. In order to halt the very significant deterioration in the public finances and to then put them back on a sustainable footing over the medium-term the following actions are urgently required --

Current Expenditure

- The expenditure savings agreed for 2008 and 2009 must be implemented in full.
- No new discretionary spending measures should be taken.
- The Minister finds it difficult to see how any pay increase for the public sector can be afforded in 2009.
- An immediate embargo on public sector recruitment, except in exceptional circumstances to be sanctioned by the Department of Finance.

Capital Expenditure

- The 2009 capital plan cannot be implemented in full. Priority will be given to those projects that enhance the productive capacity of the economy. The ongoing capital review will identify such priority projects.

Further Action

- The Minister intends to immediately appoint an independent group to advise him on all expenditure for 2009 and report back to him by the end of September.

21. Ministers have been asked to report to the Minister for Finance by 15 September on the basis of no increase in funding for 2009 over the 2008 adjusted figure. While this is still required, it is now clearly not enough and the results of this will be reviewed by both his Department and the independent review group mentioned above. On receipt of this analysis and in the light of further fiscal and economic data, the Minister will then work to develop a credible plan to ensure that the current deterioration is arrested and the overall public finances are put back on a sound footing over the medium-term.

22. The Minister would like to remind his colleagues that if action is not taken now through the deferral or cancellation of spending plans (current and capital) wide-scale tax increases are inevitable and over the medium-term further additional increases will be required to finance increasing borrowing. It must be borne in mind that the position is not sustainable even in the short-term and the Minister cannot rule out tax increases in the context of the forthcoming Budget. Wide-scale tax increases are not the preferred option and would be counter-productive and are not the best solution as doing so lowers the rate of future growth.

23. Provided the necessary budgetary adjustment is secured the Minister for Finance would consider what options exist to allow the Government to specifically take further steps to underpin economic confidence and growth and in particular to further enhance productivity and give help to the export sector.

1. Promotion of sustainable lending practices

The plan assumes controlled lending growth €3bn in 2009 & 2010 increasing by 5% pa after that. There is no consideration of diversifying the lending model which is driven off the back of established relationships with net worth individuals predominantly in the property sector. There is no residential mortgage book. Effectively, this is close to "closing shop" on lending which is not unexpected given the "monoline" nature of the business model, and the contraction in the building/rental sector

2. Controlling Asset Growth

Lending is restricted to €3 bn for 2009 & 2010 and the loans to deposit ration is planned to reduce from 140% in 2008 to 115% in 2010 to 94% by 2013. There is a proposed increase in debt securities and interbank placements

2. Controlling Asset Growth	2008	2009	2010	2011	2012	2013
Proposed de-leveraging (debt securities)	24.2	21.3	23.5	31.9	39.2	53.1

3. Securing long-term funding

The key focus is to increase customer funding to over 70% of the funding base by 2010 (54% in 2008). The plan also envisages increasing secured term funding

3. Securing long-term funding	€bn	2008	2009	2010	2011	2012	2013
Customer deposits/Funding base		58%	66%	72%	72%	73%	73%
Dependency on Interbank Deposits (up to 3 mths)		20.5	12.4	7.4	5.4	5.4	5.4
Inflows from Proposed Securitisations		1.4	1.2	4.7	7.7	10.6	13.6

4. Improving capital ratios

The plan projects a pre-impairment profit of €10bn over the 5 year period. This is projected to give rise to €5bn of internally generated capital (allowing for €3.5 bn of impairment). These figures assume higher funding costs (150/200 bps secured/ unsecured, higher capital costs, higher customer funds and costs at circa €300m pa. The level of impairment is critical to the assumption of profit. If Anglo use their own "worst case scenario" the retained profit figure is almost illuminated, and if the PwC level of impairments were applied the company, it would be operating at a loss. The capital ratio figures presented by the Company are dependant on retained profits.

4. Improving capital ratios	2008	2009	2010	2011	2012	2013
Projected Capital Ratios (Total Tier 1 ratio))	9.1%	9.5%	10%	10.4%	11%	11.7%
Comparison with PwC	8.4%	8.1%	7.8%	na	na	na
Impairment Charges used for calculating RWA (€M)	-724	-758	-791	-827	-652	-456
Comparison with PwC	-500	2,255	2,255			
Retained earnings (€M)	670	686	844	980	1,234	1,466

5. Update of Valuation of Assets

Apart from the application of impairment, the plan does not provide any information or indication in relation to revaluation of assets. The company has considerable exposure in land and construction fields: €60.6bn in the property and construction area: €19.7bn in land and development, and €6.6bn in higher risk unzoned or unplanned land categories. The loan book is also highly concentrated in a small number of high value individuals, some of whom are also indebted to other financial institutions.

There are four options available in relation to the INBS. These are:-

1. Do nothing.
2. Ensure an orderly run-off of INBS
3. Break-up of INBS
4. Merge INBS with another institution.

1. Do Nothing.

Prior to the current issues INBS was seeking to undertake an orderly run-off so as to realise maximum value for its members in the changed market circumstances. INBS was seeking to generate sufficient liquidity through the reduction of the loan book. In a normal environment many of INBS's loans would typically be refinanced by other institutions – frequently HBOS or Anglo – within a period of circa 30 months. Because of the liquidity crisis and the problems that that has caused for banks and the property market, most institutions will not refinance the loans of another institution and consequently the redemption rate is much slower.

As a result, assuming current market conditions prevail the do nothing option will inevitably result in the collapse of INBS. Continuous downgrades from the rating agencies will reduce the availability of retail deposits, the capital markets have been closed to INBS since the advent of the credit crunch, and for the reasons described above the redemption rate on the loan book is much slower than previously.

A collapse of INBS would have implications for the circa 180,000 depositors and result in a distressed sale of the loan books. Given the high level of property related lending in all financial institutions this could have serious consequences as valuations in all institutions might then have to be set to reflect distressed levels. The rating agencies in particular are likely to use any benchmarks set in their appraisals.

In the absence of action there will be severe outflows of capital from Ireland. INBS has circa €2.3 billion of overseas deposits which will leave Ireland, the debt securities in issue of €5.9 billion are sourced overseas and many of the Irish depositors withdrawing money are putting it with Northern Rock as it is deemed to be the UK Government.

While it is evident to everyone that there is a serious financial problem in Ireland – emanating from the impact of the credit crunch on the economy and the dependence of the economy at all levels on property – inaction leading to collapse will be seen as a lack of leadership and confirm the international perception that Ireland does not know how to deal with its problems.

2. Ensure an Orderly Run-off of INBS

As previously mentioned, prior to the current issues INBS was seeking to undertake an orderly run-off so as to realise maximum value for its members in the changed market circumstances. The focus was on repayments, with lending confined to pre-existing commitments and to existing borrowers when funding was required to bring projects to a certain stage. As of August 31st there was a net reduction in the loan book of circa €600 million.

In the absence of support, in the current market conditions, it is unlikely that INBS will have sufficient funding to get the time to have an orderly run-off.

The immediate issue of INBS could be avoided in a number of ways:-

- a) Provision of liquidity on a covert basis
- b) Provision of liquidity on an overt basis
- c) Nationalisation
- d) Amalgamation with another institution
- e) Guarantee Deposits

Any solution which does not provide confidence to the depositors will ultimately cost more in cash terms as the State will have to replace the deposits or other funds which leave due to that lack of confidence.

(a) Covert Funding:

If covert funding was provided to INBS to meet its liquidity needs, INBS could survive and continue an orderly run-off. The timing required to do this will depend very much on when the lending markets in the UK return to normality and whether they remain frozen in relation to property.

Covert funding will not protect INBS from further downgrades. Downgrades are likely due to the uncertainty in relation to INBS's ability to meet repayments on its Debt securities. The rating agencies will not take cognisance a funding source which is unexplained and uncertain. Ongoing downgrades are likely to result in a continuous outflow of deposits – with the overseas deposits likely to go very quickly.

There is also a need to consider what public announcements would be required due to Listing requirements depending on the funding being required.

Utilising covert funding is likely to require much more money from the State than would be required if public confidence was restored.

(b) Overt Funding

Overt funding with the appropriate supporting statement is beneficial to both INBS and the market. As is evident from the UK, overt funding with the wrong message can amplify difficulties.

Overt funding which is focussed on a single institution will inevitably raise questions on other institutions. At its simplest if one knows one institution is safe but one is uncertain about the others then inevitably one will put one's money with the safe institution.

(c) Nationalisation

At first glance this looks like the easy way to deal with the current issues. This, however, ignores the fact that the problems are market wide and will inevitably bring into focus whether other institutions may be nationalised.

The threat of nationalisation of institutions is effectively a threat to wipe out the equity in those institutions. In such a position no rational investor is going to provide equity or near equity to an institution which might be nationalised.

Nationalising a single institution, in the absence of guaranteeing the deposits with the others will inevitably exacerbate the problems with the others.

(d) Amalgamation with another institution

The issues associated with this are discussed later as Option 4, in the context mainly of Anglo Irish Bank.

(e) Guarantee Deposits

The easiest way to facilitate an orderly run-off of INBS is for the State to publicly give comfort that no depositor or equivalent is at risk.

Advantages:

This is the least disruptive option from a national perspective. It gives a clear signal from the State that it is not prepared to countenance failure and that no creditor of an Irish financial institution is at risk.

Risks:

Any ambiguity in the statement of comfort could precipitate problems.

Wider Implications:

With the State giving public comfort on the security of funds with INBS (as the smallest institution) this will inevitably imply that the State will provide similar comfort to larger institutions. Most analysts already assume this is the case for the two main institutions. However confining the Guarantee to INBS may leave Anglo with a problem as its Irish depositor base is much smaller.

The admission that INBS requires such support will raise issues in relation to other institutions. However, these same issues are brought even more into focus if a collapse occurred.

(Note: In the absence of the comfort being absolutely public this solution would not work as the rating agencies would continue the downgrades. This would result in continuous outflows increasing the magnitude of the funding problem. Goldmans have advised that in the Bradford and Bingley situation that the rating agencies would not take account of implied support.)

3. Break-up of INBS

A break-up of INBS would probably involve an attempt to:

- a) sell the deposit book, the branch system and the 180,000 customers.
- b) sell the mortgage book
- c) sell the developer book in one or two components – potentially separating the UK and Irish elements.

In effect there is no difference, other than timing, between Option 3 (Break up of INBS) and Option 2 (providing sufficient support to enable an orderly run-off). Following Option 3 on an accelerated basis results in greater value destruction and almost certainly causes wider market problems.

While in theory this is an option the implementation might prove difficult as it would not necessarily be possible to do it on an overnight basis. In the current market circumstances the sale of the developer loan book is likely to be at a substantial discount as the only likely buyers are private equity funds looking to buy from forced sellers. Such a forced sale valuation would provide a very negative cross read to other Irish banks with property exposures.

The only way to avoid a heavily discounted sale of the loan books would be for the State to underwrite the losses or for the State to take over the book at face value and to pay another institution to manage the book on its behalf.

In normal market circumstances the sale of the deposit book would be likely to generate a substantial premium, however given the current period where the retail market has become much more rate sensitive the premium is probably substantially reduced. Depending on the buyer the customers and branch system may be of value. Clearly they would have no value to the main banks who already have a full branch system and probably the same customer base.

4. Merge INBS into another Institution

The only institution which has indicated a willingness to consider a solution is Anglo.

Advantages:

1. Anglo is best positioned to manage the developer loan book. It will have many customers in common. It understands the relevant markets in great detail and it has the experience of working with people in more challenging times.
2. Relative to a straight runoff where customers have no need for long term loyalty the management of the book by someone with overlapping clients is likely to generate a better result. Against this must be balanced the inherent conflict of interest if the deal structure results in the same person managing two overlapping loan books – one where you have all of the downside and the other where you have none.
3. A solution focussed on Anglo avoids further concentration in the banking market. Anglo would get an initial customer group of circa 180,000 and a branch network of 50 outlets. There would be no branch closures as a result.

Solution:

Any solution must be one that can be executed very quickly. In any takeover of INBS, Anglo have indicated that they would require –

- a) To be seen as the State's preferred solution provider. Given the initial meetings between the FSR and AIB/BOI there is clearly a risk to this.
- b) Anglo must be seen to be insulated from any downside that may exist in the developer book.
- c) Anglo would have to be protected against any severe outflow of funds following an acquisition.

Outline Anglo Proposal

1. Anglo takes full control of the business with a view to:
 - (a) managing out lending assets to maximise value.
 - (b) effect synergies where possible.
2. The acquisition to be effected through a bankruptcy remote SPV, which will not be consolidated with Anglo for capital purposes.
3. Government underwrites the SPV as to any:
 - (a) deficit in net assets.
 - (b) funding and liquidity support provided with funding secured on SPV asset.
4. Consideration to be in shares and on a basis to be agreed, but largely based on realised net assets.

Risks:

Merging INBS into any bank will be publicly seen as a bailout. Clearly this will bring focus onto the Irish market and the share price of the entity INBS is merged into is likely to fall. This can only be counteracted by very significant support for the entity into which INBS is merged.

The State needs to be very careful not to compound its risks. Anglo is already seen to be a property focussed bank and in the absence of very clear support this solution would not work. While INBS's loan book is less than 10% of the level of those in AIB/BOI, Anglo's is over 50%.

In effect the State **will** have to guarantee Anglo at the same time – it may not be sufficient to guarantee the liquidity and assets of the SPV.

The other major institutions may be strongly opposed to such a “sweetheart deal” for one of its competitors.

The State will be seen to be taking on a much bigger and more complicated problem than was necessary.

Conclusion:

There is a real danger that the market will not accept this as a solution unless there is an unequivocal statement from the State that it will provide whatever support is necessary to Anglo. The international market may react with cynicism and put the focus on the loan books of the two major institutions. The September 10th JP Morgan report on the Irish Banks noted that “75% of accumulated lending since 1999 has been collateralized with property assets and 50% of lending originated in the last 3 years”.

Jim Deery

From: Brendan McDonagh
Sent: 21September 2008 09:41
To: 'Kevin.Cardiff@finance.gov.ie'; 'William.Beausang@finance.gov.ie'; John Corrigan; Oliver Whelan
Subject: Fw:Questions - INBS for GS meeting

Categories: Red Category

Kevin,William,

Further to the request re questions for GS on their work on INBS commercial loan book.

33 items I can think of that are obvious I suppose. These questions are the type I would expect answers to, no doubt more will come to mind to me once I see the Gs report or if at the meeting as GS make their presentation. I probably have not listed the key question but no doubt yourself and William will think of it.

I think we need to be careful with GS as they no doubt have a fiduciary duty to INBS to put the best possible scenario forward to FR.

Also I think it would be no harm to share the Gs information with PwC to get their view. If MS can become States advisors without conflict then I would seek their views also.

I hope this helps. My mobile will be off from 3pm to 6pm whatever the result today.

No doubt John or Oliver may have more ideas on key questions so I have copied them in.

Give me a call about I am if you need to clarify anything.

Regards

Brendan

1. What is the current value of top 30 loans and also entity exposures?

2. What percentage of INBS €9.5 bn commercial loan book is this?

3. How many of those top 30 exposures involve the same principals eventhough they may have different companies or SPV's?
4. How much is value terms has those same principals?
5. Who are top 10 INBS exposures to? What €value is this of €9.5 commercialloan book?
6. Are there loan emcumbrances or charges on loans that prevent them offering up as collateral?
7. What type of emcumbrances and charges?
8. What is €value ofthese type of loans that cannot be used for collateral?
9. List the type of restrictions and clauses you have found or advised of in INBS commercial loan book?
10. How much of these loans have back to back agreements e.g. borrower also has deposits with INBS?
11. What is typical size of back to back deposit vs loan?
12. Has there been any reduction in these back to back deposits since end 2007?

13. Are these back to back deposits contractual or gentlemans agreement?
14. What percentage of loan to value {LTV} ratios are in top 50% of INBS loan book exposure by value?
15. Is this LTV at time of origination or as of now?
16. What is KPMG's analayis of the loan book?
17. Have KPMG issued a current report? If so please provide a copy to FR?
18. What percentage of loans are non performing as at 31/8/08?
19. What percentage of the current €9.5 bn of the commercialloan book are involved in rolled up interest?
20. What is €current value of rolled up interest?
21. What percentage of the INBScommercialloan book involves rolled up Interest?
22. How much will this rolled up interest contribute to 2008 Profits?

23. What is I NBS current impairment provisions as a percentage and (value compared to end 2007)?
24. What will this provision be at end 2008, what is KPMG's view?
25. What percentage of the (9.5 bn loan book is non performing?)
26. What is breakdown of these non performing loans in terms of number of months?
27. Has I NBS entered into new schemes with borrowers that stopped paying interest since start of 2008?
28. How much of the €9.5 bn loan book is tied up with I NBS associate companies, subsidiaries or JV's?
29. How does the quality of the I NBS loan book compare with GS knowledge of other entities?
30. How quickly can the commercial loan book be packaged up and used for collateral?
31. What is the average life of the I NBS commercial loan book?
32. What is ITV of the whole book at origination and as at 31/8/08?
33. It would be no harm to get a list of the top 30 exposures from GS and the individual loans and their analysis.

From: Brendan McDonagh <BMcDonagh@ntma.ie>
Sent: 28 September 2008 14:54
To: Beausang, William
Subject: FW:

From: john.loughlin@ie.pwc.com [mailto:john.loughlin@ie.pwc.com]
Sent: 28 September 2008 13:55
To: Brendan McDonagh
Cc: denis.g.oconnor@ie.pwc.com; aidan.walsh@ie.pwc.com
Subject:

Brian,

As requested, there follows a summary of the scenarios for the 3 banks discussed this morning.

Anglo

. for the week ending 3 October management's best estimate shows a small cash balance at the end of the week of E84m. However, because of the assumption that interbank deposits of E1.5b will not rollover on 30 September there is a negative cash balance of E128m on 30 September

. if the Irish CMBS is not completed on 30 September the negative cash balance increases to E2.2b on that day

. the estimate assumes that the E1.5b of interbank deposits will again be available on 1 October. If this assumption is correct, but the CMBS is not completed, then the shortfall at the end of the week is about E2b. If the interbank deposits cannot be renewed the shortfall at the end of the week is about E3.5b. Please note that management believe that these can be renewed, consistent with recent experience. However, as you know the markets are extremely volatile at the moment and it is difficult to predict whether the funding will be available

. under management's "worst case" scenario the shortfall increases to E2,449m on 3 October. If the CMBS is not completed this increases to E4.6 billion. To avoid this the withdrawal of deposits needs to cease, assuming that the interbank and capital markets remain effectively closed for the immediate future

. by Friday 24 October the shortfall increases to E4.9 billion and to E9.8b in the "worst case" scenario. If the Irish CMBS is not complete by the end of October these numbers increase to E7b and E11.9b

. the "worst case" scenarios include substantial cash outflows, in excess of experience in the past week

INBS

- . closing cash on 27 September was E3b
- . management's estimate shows a reduction to about E2b at the end of October
- . the key assumption is the level of deposit withdrawal. If this increased from E25m to E50m per day in ROI there would be further withdrawals of about E700m, reducing headroom at the end of October to about E1.3b.
- . if the current level of deposit withdrawal continues in November and December there may be insufficient funds to finance 2 EMTN payments totalling E630m
- . it would be advisable to have a contingency plan for E1b in December to allow for the EMTN payment and some headroom on deposit withdrawal

ILP

- . there was cash of about E2b on Friday 27 September
- . This was higher than expected because an estimated level of corporate deposit withdrawals of E1.5b did not materialise
- . management have prepared a very worst case scenario assuming no corporate deposits roll. This indicates a shortfall of E81m on Monday 29 September rising to E1.2b by Friday 3 October. The shortfall reaches its peak on Thursday 9 October when it reaches E2.1b
- . historically about 80% of corporate deposits have been renewed. Reducing this to 50% in light of current market conditions would increase available cash on Friday 3 October by E1.2b i.e just about covering the deficit on that day. The deficit on the previous days would also be covered, by about E780m on 29 September, the best of the days, and by about E100m on Thursday 2 October, the best of the days prior to 3 October. The 50% of deposits not renewing assumption has been applied to the E1.5b rolled on Friday 25 September since I understand that this is 24 hour money and so 50% is assumed not to renew on Monday.
- . based on the 50% assumption there will be a shortfall of about E200m on Monday 6 October, rising to E500 to E600m by 9 October, just prior to a E1.8b increase in available ECB collateral
- . assuming the ECB collateral increases by E1.8b on 10 October, and corporate deposits are renewed at a rate of 50%, there is headroom after this date. This will be increased if the proposed Residential

Mortgage securitisation of E2b can be completed on 10 November. Further securitisations are possible in December

. I stress that the 50% is an assumption that we have made for illustrative purposes and we need to get management's working assumptions when we see them tomorrow. We will update our report for this

Summary

. in the week commencing 29 September it would be advisable to have contingency plans in place to finance Anglo's E2.1b CMBS if this the paperwork is not completed on time. It would also be advisable to have a further E1.5b to E2b available if Anglo is unable to raise E1.5b in the interbank market on Wednesday, to cover the estimated shortfall of E128m on Tuesday, and if corporate and retail deposit withdrawals are more than estimated

. it would also be advisable to have contingency plans in place for ILP, since the assumption of 50% non renewal of corporate deposits leaves the cash position very tight by Friday. Perhaps E500m to E1b. Even if this is not required in the week commencing 29 September there is a higher possibility it would be required the following week, unless the deposit outflow stops

. longer term Anglo's deficit increases to E4.9b by 24 October and is likely to increase further thereafter, unless the outflow of deposits stops. In a "worst case" scenario the deficit increases to E9.8b by 24 October. If deposit withdrawals continue the numbers get progressively worse thereafter

. it would be advisable to have a contingency plan for INBS for December of up to E1b. However, if the deposit outflow stops or reduces in this period this may not be necessary

I am providing these comments at your request but please note that our work is not complete and our final comments will be contained in our final reports in accordance with our engagement letters. Also we have not had an opportunity to discuss the comments with management of the 3 institutions. In particular the assumptions for ILP will need to be changed when we receive management's working estimate. This may improve or disimprove the situation. Finally, as we all know the markets are extremely volatile at the moment and it is impossible to accurately the actual level of deposit withdrawals. The numbers above are simply estimates to facilitate contingency plan to be drawn up.

Please feel free to call me on 086 3210050 if you have any questions.

Best regards. John Loughlin.

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Note on sub-group meetings to prepare Ministerial briefing
Saturday 13 December 2008

1. Sub-group meeting to draft options note on Anglo Members:

Kevin Cardiff (Dept. of Finance)
Padraig O Riordán (Arthur Cox)
Brendan McDonagh (NTMA)
Tony Grimes (Central Bank)
Eoghan Duffy (Dept. of Finance)

Overview:

Function of the meeting was to draft an options note for consideration by Minister / Govt., outlining 3 options for consideration, specifically with regard to Anglo Irish Bank. The options were:

- Nationalisation
- Govt. underwriting of capital raising by Anglo
- Govt. taking a controlling preference share in Anglo

Each option was set out under the headings of: What the option involves, What the consequences would be for existing shareholders, Timing considerations, and, Advantages and Disadvantages.

Discussion centred on the market consequences of each option. Group was able to agree without any significant objections the content under each heading. Resulting note attached as Appendix 1.

2. Sub-group meeting to draft note on rationale for recapitalisation

Members:

Ann Nolan, Sean Kinsella (Dept. of Finance)
John Corrigan (NTMA)
Con Horan (Financial Regulator)
Cormac Kissane (Arthur Cox)

Overview:

The group noted that its terms of reference were to draft a short paper examining the rationale for the recapitalisation of Irish banks and establish the main benefits and drawbacks to such an approach. The paper is attached as an appendix.

It was agreed that before the detailed pros and cons of recapitalisation were debated, the group would set out the context for proposed recapitalisation with particular reference to the Government's guarantee scheme. The group agreed to highlight the guarantee's effect in stabilising the Irish financial system and securing liquidity.

Furthermore, the group agreed to stress that the threat to stability and liquidity was likely to return given the market's current expectations regarding capital levels in banks, and recent capital injections in other jurisdictions.

Supplementary Questions:

PUBLIC FINANCES & BUDGET 2009

Q. What is the likely end year tax shortfall?

A. I have already stated, my Department will publish an updated view on expected tax and Exchequer positions at the end of this quarter when we have all of the facts to hand in relation to the first nine months of revenue receipts.

Q. Why has tax revenue deteriorated so rapidly?

A. The Irish economy has suffered a very large growth shock with GDP growth falling from the 6% recorded in 2007. The sharp deterioration in economic growth, driven by international conditions and a correction in the property market, is obviously strongly affecting tax revenue receipts. In particular, the developments in the housing market can be seen in the performance of VAT, CGT and Stamp Duty receipts, which together made up over 75% of the shortfall on expected levels of revenue in the first eight months of the year.

Q. What will the Budget do to solve the problems in the public finances?

A. As the Deputy knows Budget 2009 will be presented to the Dáil on Tuesday, 14th October. Decisions in relation to Budget 2009 are currently being formulated for consideration by Government in advance of Budget day. The overall level of government borrowing that may be required will depend on a number of variables. At this stage in the process I do not intend speculating in advance of the annual Budget on what it will contain. This is the normal procedure and I do not propose to deviate from this practice now.

Q. Why didn't the Government take action earlier?

A. At the end of June, tax revenues were €1.45 billion behind expectations. On this basis, a €3 billion shortfall was called for the year. In addition, in recognition of known spending pressures mainly reflecting the weaker labour market and resulting increase in the Live Register, the Government in July announced a savings package of €440 million in 2008 and €1 billion in 2009. The purpose of these measures was to make certain adjustments within the overall expenditure

amounts. We also made it clear that additional economies would be required in the event that the fiscal position deteriorated further.

In July and August, the tax shortfall worsened by a further €1.3 billion with the pace of the shortfall quickening. Consequently, the Government decided to bring forward the Budget in order to set out steps to stabilise and restore balance to the public finances over the medium term. Taking decisive action now is critical to our future sustainable growth and the Government is determined to ensure that Ireland's economy is in the best possible position to resume trend growth as soon as international conditions improve.

Q. What steps will you take in the Budget to counter-act the tax shortfall?

A. We have brought forward Budget 2009 to 14th October. The Budget will reflect the necessary prioritisation of expenditures in light of expected tax revenues. The Budget will set out steps to stabilise and restore balance to the public finances by, amongst other things, prioritising current and capital public expenditure. As I have said, I will not comment on the contents of the Budget in advance of that date.

Q. Is bringing the Budget forward purely a cosmetic exercise?

A. The Budget sets out the Government's taxation and expenditure plans for the next three years. This is not a cosmetic exercise and is extremely important in setting out a programme of sustainability in the public finances. This will give clarity and confidence to investors and taxpayers alike and provide a sound basis for economic recovery.

Q. How will the Minister accurately forecast the remaining months of 2008 without the data he normally has available?

A. In formulating the Budget every year it is necessary for my Department to make an estimate on the expected outturn for the current year in advance of the receipt of all revenues for that year. As the Budget is traditionally held on the first Wednesday in December, it is normally only tax receipts for the month of December that must be estimated. Obviously this year it will be necessary to make an estimate of the outturn that covers a longer period of time than is the norm.

considered by the government are the taxation of child benefit,¹¹ the introduction of a carbon tax, some form of property tax and the elimination of reliefs and exemptions.

In preparing our forecasts for the public finances this year and next, we have factored in the broad figures on tax and spending that have been included in the various announcements by the Government. For 2010, we do not have precise details on which taxes will be increased and on how spending will be reduced so we have had to make some operational assumptions. As an illustrative package, we have increased income tax by €850 million, raised excise taxes by an additional €100 million. The other €800 million has been allocated to a carbon tax (€600 million) and a property tax (€200 million). On expenditure we have imposed in full a cut of €1.5 billion on current spending on goods and services and €750 million on the capital spend.

We now expect the government to collect just under €34 billion in current revenue in 2009, a fall of 18.8 per cent relative to 2008. With current spending forecast at €46.4 billion, the deficit on the current side is expected to be €12.5 billion. When combined with the capital deficit of €9.2 billion, the Exchequer Deficit will amount to €21.7 billion. On a general government basis, this implies a deficit of €20.0 billion or 12.0 per cent of GDP. This figure is higher than the deficit figure in the Supplementary Budget of 10.75 per cent. The difference partly arises from our lower forecast from net current revenue relative to that of the Department of Finance, due in turn to a lower forecast for growth this year. Where we envisage current revenue of €33.9 billion, their figure is €35.2 billion. It is also partly related to our lower estimate for nominal GDP.

For 2010, some recovery in current revenues is now anticipated based in large part on the level of tax increases to which the Government has committed itself. Current revenues are expected to rise to €36.1 billion, an increase of 6.2 per cent on the level expected in 2009. When combined with forecasts for spending, the overall impact is for the general government deficit to fall in 2010 relative to 2009, to 11.5 per cent of GDP.

The gross general government debt is now expected to reach 57.7 per cent of GDP in 2009 and 70.3 per cent in 2010. At the end of 2008 the net debt figure in Ireland was just 20 per cent of GDP compared to a gross debt figure of 41 per cent. The difference between these two figures was primarily due to the National Pension Reserve Fund (€16.4 billion), the Social Insurance Fund (€2.8 billion) and cash balances (€20 billion). In 2009 it is estimated that the Social Insurance Fund will be exhausted due to the rapid rise in unemployment. The NPRF is also likely to shrink in value, mainly due to plans for recapitalisation of the banks using these funds.

¹¹ Means-testing of child benefit payments was also mentioned by the Minister in his speech as a possible way of reducing the cost of the payment.

The National Recovery Plan

2011-2014

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Overview and Summary

This Plan provides a blueprint for a return to sustainable growth in our economy. It sets out in detail the measures that will be taken to put our public finances in order. It identifies the areas of economic activity which will provide growth and employment in the next phase of our economic development. It specifies the reforms the Government will implement to accelerate growth in those key sectors.

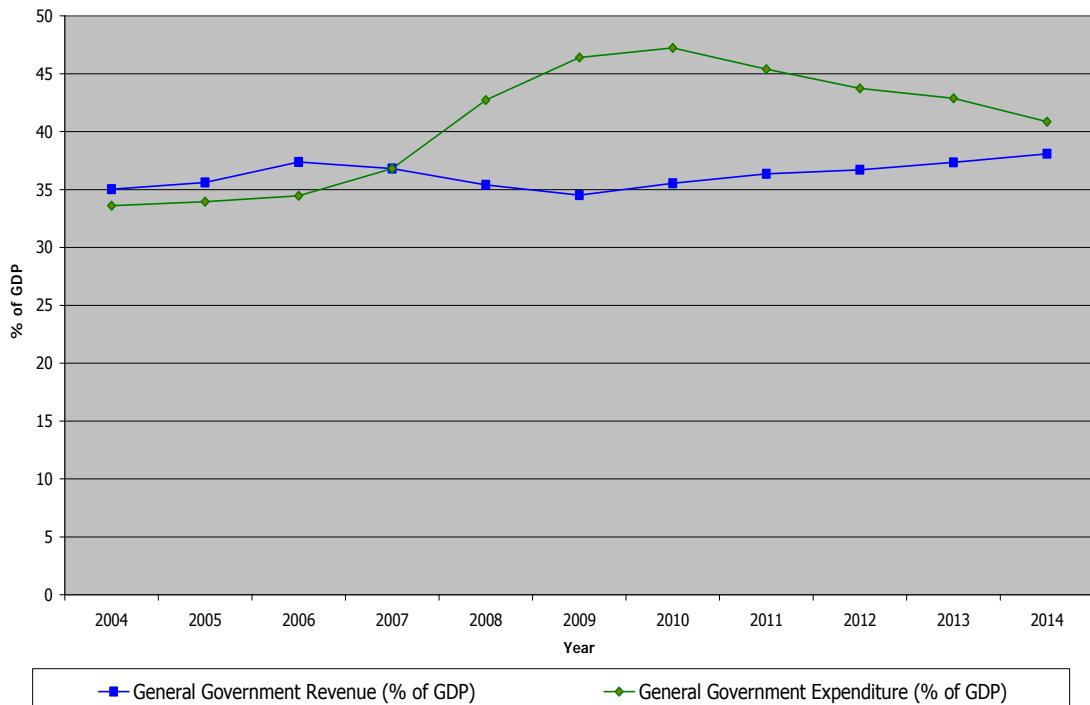
Reducing the budget deficit will not, by itself, solve our economic difficulties. We must build on our strong export performance by improving our competitiveness. We must enhance our productive capacity by maintaining investment in key infrastructure projects and in education. We must remove barriers to employment and ensure that those who have lost their jobs are retrained and are ready to take up employment as the labour market recovers. This Plan sets out the key reform measures the Government will take to return our economy to a sustainable medium-term economic growth path.

The Plan will help dispel uncertainty and reinforce the confidence of consumers, businesses and of the international community. The tax and expenditure measures contained in this Plan will negatively affect the living standards of citizens in the short-term. But postponing these measures will lead to greater burdens in the future for those who can least bear them, and will jeopardise our prospects of returning to sustainable growth and full employment.

Over the last two and a half years, we have responded promptly to the deterioration in the public finances. In five separate adjustment packages, savings and revenue-raising of around €14.6 billion on a full year basis have already been achieved. As a result our public finances have stabilised with an underlying deficit of 11.7% of GDP in 2010 compared with an implied uncorrected deficit of 20% of GDP. Notwithstanding the size of the adjustment, our economy has performed better this year than had been forecast at the end of 2009, with GDP growth expected to be marginally positive as opposed to a contraction of 1.3% which had been predicted this time last year.

Unfortunately, lower than expected medium-term economic growth prospects as well as higher debt interest costs arising from the bank rescue have required us to revise our budgetary targets. To achieve a deficit of below 3% of GDP by 2014, the Government has concluded that an overall saving of €15 billion is required. The European Commission acknowledges that this is the appropriate target based on the growth projections we have set for the period of the Plan.

Public Finances 2004 - 2014



To demonstrate the seriousness of its intent, the Government has decided that 40% or €6 billion of the €15 billion adjustment will be made in 2011. This commitment to the early delivery of the Plan will engender confidence at home and abroad that we can restore order to our public finances. The adjustment will be made up of €10 billion in spending reductions and €5 billion in tax and revenue raising measures. These are demanding but realistic targets. With a concerted national effort, they can be achieved.

From the late 1990s, the benefits of our booming economy were felt across every section of the population. Working-age social welfare rates are now more than twice their rate in 2000. Over the same period, the State pension almost doubled. These increases were well ahead of the cost of living.

Public service pay also increased well ahead of inflation. From 2000 to 2009 average public service salaries increased by 59%. At the same time, taxation was reduced. During the period after 2000, the entry point to income tax increased from €7,238 to €18,300 for PAYE earners and since 2000, bands have widened by 105% for the single person and married two earners. Credits have increased by 92% since their introduction in 2001. The standard and higher tax rates fell from 26% and 48% in 1997/98 to 20% and 41% by 2007.

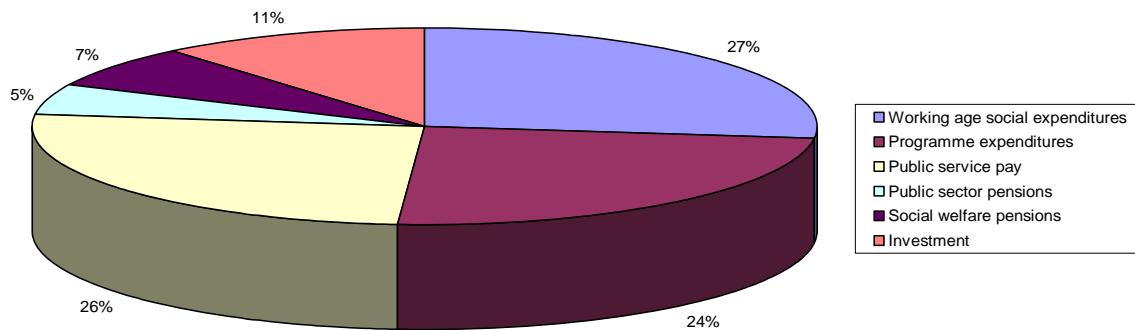
As a result of these changes, the proportion of income earners exempt from income tax increased from 34% in 2004 to an estimated 45% in 2010. It is now estimated that for the current year, 42% of income earners will pay tax at the standard rate and just 13% will be liable at the top rate.

The substantial reductions in tax and increases in welfare were made possible by the very high level of property-related tax receipts taken in by the Exchequer during the boom years. The property boom also swelled VAT and other receipts. In 2007, capital taxes and stamp duty yielded €6.7 billion. This year, that figure is expected to fall to as low as €1.6 billion. In these dramatically changed circumstances, it is clear the State can no longer afford the current levels of social provision and personal taxation.

The effect of the spending reductions for 2011 detailed in this plan will be to bring us back to working age social welfare rates slightly above 2007 levels. The income tax measures, outlined in Chapter 6, will bring us back to levels prevalent as recently as 2006.

The major drivers of public spending are Public Service Pay and Pensions; Social Welfare and Public Service programme spending; and Public Investment.

Gross Voted Public Spending 2010

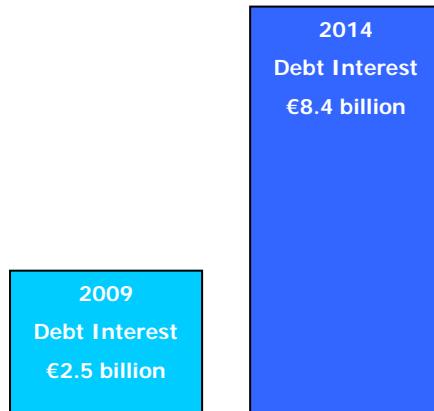


The bulk of the savings we must achieve will have to come from these categories. The Government is determined to eliminate waste and make maximum savings from efficiencies. But it is simply not credible to suggest that our public finance difficulties can be resolved without impacting on the public service pay bill, social welfare or public services.

General Government Gross Debt¹ is expected to be 95% of GDP by the end of 2010 and will peak at 102% in 2013, before falling to 100% by 2014. We cannot continue to accumulate debt at this pace without damaging public services. As it is, an ever-increasing proportion of tax revenue is being diverted from much-needed public services to pay the interest on our debt which has a first call on our resources. For this reason, it is critical that an immediate and significant reduction is made to our reliance on borrowing to finance our running costs.

¹ The estimates of General Government Debt contained in this Plan do not take account of any additional support to the banking system that may be part of a negotiated programme of external assistance.

Exchequer Debt Interest Comparison 2009 and 2014



Note: The €8.4 billion above is a post-consolidation figure. The 2009 amount represents about 8% of tax revenue while the 2014 amount represents 20% of projected revenue for that year.

No person, group or sector can be absolved from making a fair contribution to the resolution of our economic difficulties. The measures contained in the Plan are proportionate. We must all accept our share of the burden so that we can collectively share in the fruits that will undoubtedly flow from solving our current problems.

Significant and lasting gains have been won for this country over the period of our boom. For example, the decisions to pay down the national debt and set up the National Pensions Reserve Fund have strengthened our capacity to deal with this economic crisis. The transformation of our public infrastructure and our investment in education has served to increase our competitiveness and put us in a position to take advantage of recovery in the global economy.

The scale of the spending adjustment we must now make dictates that investment must be curtailed. But the careful funding choices made in this Plan seek to protect core areas of economic investment such as education and supports for enterprise and innovation for the development of the smart economy. Investment in key social infrastructure such as public transport, hospitals, schools, water and environmental services will also be maintained.

This Plan reaffirms the Government's unambiguous position on the maintenance of the 12½% rate of corporation tax. This is a cornerstone of our pro-enterprise, outward-looking industrial policy and has remained consistent over successive administrations.

Our budgetary adjustments over the last two and a half years have stabilised our public finances. We must now continue on this path by adhering to the targets set out in the Plan. The strategy and these targets in particular will be reviewed annually and action will be taken in the event of any deviation from the central projection.

This Plan is based on the information available up to mid-November 2010. The figures referred to in the document may change as a result of policy decisions taken by Government after publication.

Macroeconomic Principles and Outlook (Chapter 1)

While the budgetary adjustment required is substantial, the prospects for a return to growth are favourable. Ireland is a small, open economy and export performance during the recession has been markedly robust.

The vitality and dynamism of our economy depends on the health of our export sector which in turn stimulates domestic demand and creates jobs. The strategy underpinning this Plan will stimulate broadly-based export-led growth to increase output, to return to sustainable employment creation and to assist recovery in the domestic economy.

Many of the essential conditions for a resumption of export-led growth are in place: our road network and our public transport system have been transformed; we have one of the best educated workforces in the world; and our tax system supports enterprise and innovation. This Plan sets out the measures we will take to increase productivity and rebuild our competitiveness.

The current account of the balance of payments is expected to return to surplus in 2011 and record a steadily rising surplus over the following three years. This means that from next year the economy as a whole will no longer be borrowing from the rest of the world.

Macroeconomic Outlook 2011–14

The reforms set out in this Plan will lead to a more stable macroeconomic position:

- Real GDP will grow by an average of 2¾% in the years from 2011 to 2014;
- From 13½% in 2010, unemployment will fall below 10% in 2014.

Budget Strategy (Chapter 1)

Approximately two thirds of the budgetary adjustment (€10 billion) will be achieved through expenditure savings and one third (€5 billion) through revenue-raising measures. Within the expenditure saving of €10 billion, current expenditure will be reduced by €7 billion and capital investment by €3 billion.

Budget Strategy 2011–14

The Plan will correct budgetary imbalances:

- €15 billion budgetary correction over 4 years;
- €10 billion in public expenditure, €5 billion in tax and revenue raising;
- 40% or €6 billion will be front-loaded in 2011;
- Deficit will be reduced to 9.1% of GDP in 2011 and to below 3% by 2014; and
- Debt to GDP ratio will peak at 102% in 2013 and will fall to 100% by 2014.

Strategy for Competitiveness, Growth and Employment (Chapter 2)

Government policy must support the private sector by removing potential structural impediments to competitiveness and employment creation, and by pursuing appropriate sectoral policies to encourage export growth and a recovery of domestic demand.

At present, the level of the minimum wage is out of step with an economy where GNP has fallen by 19%. Other labour market regulations are preventing job creation – especially in sectors where unemployment among younger and less-skilled workers is most prevalent. Decisive reform is required.

Welfare and labour market policies must reward work and provide a pathway to employment, education and training opportunities for those who have lost their jobs. Reforms in this area, along with measures to enhance competitiveness, are pivotal to growth in our economy.

Competitiveness, Growth and Employment

The Government will:

- Reduce the minimum wage by €1 to €7.65;
- Reform welfare system to incentivise work and eliminate unemployment traps;
- Complete a review to eliminate anomalies in Registered Employment Agreements (REAs) and Employment Regulation Orders (EROs) within three months; and
- Reinforce activation policies to ensure that unemployed people can make a swift return to work.

Cost competitiveness:

- Promote rigorous competition in the professions and measures to reduce legal costs;
- Take decisive actions to reduce waste and energy costs faced by businesses including the development of Smart Grids and renewable energy;
- Enhance availability of technological infrastructure, in particular next generation broadband networks;
- Lead efforts to reduce office rents in both the private and public sectors; and
- Increase efficiency in public administration to reduce the costs for the private sector.

Sectoral Policies:

- Implement sector-specific measures to assist an increase in exports as well as an increase in domestic demand.
- Support innovation through the innovation fund, other enterprise supports and the tax system, and encourage small business development.

Expenditure Measures (Chapters 3, 4 & 5)

The job of Government is to create the conditions in which enterprise can flourish and jobs can be created. The most important of these conditions is sound public finances. Since 2007, our national income (GNP) has fallen by 15% and our tax revenues have reduced from over €47 billion to €31.5

billion and are now back to 2003 levels. In these circumstances, the current level of public spending is unaffordable. It must be returned to a sustainable level relative to the size of the economy.

The bulk of the savings will have to come from the major drivers of spending including Public Service Pay and Pensions, Social Welfare, Public Services including student supports, free or subsidised medical care and treatment and Public Investment.

The expenditure measures contained in this Plan are designed not only to return public spending to a sustainable level but also to protect those most in need and facilitate economic recovery. Careful choices have been made to target scarce resources at those most in need, to protect enterprise and to promote competitiveness. Investment in education, innovation and enterprise has been maintained. The targets set for a reduction in public service staff levels together with the full implementation of the Croke Park Agreement will create a more efficient and effective public service, a crucial component of competitiveness that will deliver better services to the citizens at a lower cost.

Capital spending must be reduced. But these reductions of €3 billion by 2014 must be considered in the context of the very substantial investment over the past decade which has transformed our road network, our public transport system, our educational institutions and our cultural, sport and tourist facilities. In the current lower cost environment, better value can be achieved from a lower level of capital investment creating a high level of capacity in the economy and delivering important social infrastructure.

Expenditure Savings

Government will:

- Reduce current expenditure by €7 billion by 2014, bringing spending back to 2007 levels;
- Reduce the cost of the public sector pay and pensions bill, social welfare, and public service programmes;
- Achieve savings in social welfare expenditure of €2.8 billion by 2014 through a combination of enhanced control measures, labour activation, structural reform measures, a fall in the Live Register, and, if necessary, further rate reductions;
- Cut public service staff numbers by 24,750 over 2008 levels, back to levels last seen in 2005;
- Reduce the public sector pay bill by about €1.2 billion between 2010 and 2014;
- Make more effective use of staffing resources with redeployment of staff within and across sectors of the public service to meet priority needs;
- Reform work practices to provide more efficient public services with scarcer resources;
- Introduce a reformed pension scheme for new entrants to the public service and reduce their pay by 10%;

- Introduce a pension deduction for public service pensioners to yield €100 million in savings;
- Reduce non-pay and non-social welfare spending by €3 billion over the period;
- Increase the student contribution to the costs of third level education;
- Introduce water metering by 2014; and
- Reform and update the existing budget system beginning in Budget 2011.

Taxation Measures (Chapter 6)

While the bulk of the budgetary adjustment is on the expenditure side, taxation must also play a role in bridging the gap between the State's income and expenditure. Revenue-raising measures will contribute one third of the overall budgetary adjustment. The tax system must be capable of raising the resources necessary to pay for essential public services in a manner that does not unduly impede economic development. The Government remains committed to the 12½% corporation tax rate: it will not be increased under any circumstances.

In 2010, it is estimated that 45% of taxpayers will pay no income tax. This is not sustainable. A fundamental principle of the reform outlined in this Plan is that all taxpayers must contribute according to their means. Those who can pay most will pay most but no group can be sheltered.

The measures contained in this Plan will broaden the tax base by bringing more taxpayers into the tax net, abolishing or curtailing a range of tax exemptions and reliefs, and introducing a new site value tax. These changes will bring us back to an income tax structure last seen in 2006. Approximately one third of the revenue raised will come from indirect tax, capital tax and other charges; one third from direct income tax; and the final third from tax expenditures.

This Plan contains a set of measures which will increase Government revenues over the next four years by just over €5 billion or approximately 3% of GDP in 2010 terms. Approximately 40% of the policy measures will be front-loaded into 2011, resulting in substantial structural reform of the income tax system.

Revenue measures

Government will:

- Maintain the 12½% corporation tax rate; this will not change;
- Raise €5 billion over the period of the Plan - 40% of measures will be front-loaded;
- Raise €1.9 billion through income tax changes;
- Implement pension-related tax changes to yield €700 million, with €240 million in tax savings on the public service pension-related deduction;
- Abolish/curtail a range of tax expenditures yielding €755 million;
- Increase the standard rate of VAT from 21% to 22% in 2013, with a further increase to 23% in 2014. These changes will yield €620 million;

- Introduce a Site Value Tax to fund essential locally-delivered services. This will yield €530 million;
- Increase the price of carbon gradually from €15 to €30 per tonne, yielding €330 million;
- Reform Capital Acquisitions Tax and Capital Gains Tax to yield an additional €145 million;
- Transform the Business Expansion Scheme (BES) into a new Business Investment Targeting Employment Scheme (BITES).

Conclusion

Our economy is beginning to recover. There will be a small increase in GDP this year. Given the 7.6% decline recorded in 2009 that in itself is remarkable. The impact of our improved competitiveness can already be seen in our healthy export figures. Both our foreign owned and indigenous exporting companies have been extremely resilient throughout the downturn. Even in the difficult trading circumstances of this year, they have increased their market share.

This Plan will enable us to build upon the many positive aspects of our economy so that we can return to a sustainable medium-term growth path. The measures it contains will:

- remove barriers to growth;
- boost our competitiveness; and
- restore order to our public finances.

Detailed policy measures identified in the Plan will build on our strengths and develop other sectors to provide a balanced economy and employment for our citizens. Our future prosperity rests upon the implementation of this Plan over the next four years.

Chapter 1 Economic Policy

Key Messages

- The economy is expected to stabilise this year before expanding at an annual average rate of 2¾% between 2011 and 2014.
- A €15 billion package of measures is required to restore order to the public finances by 2014.
- This package will comprise two thirds expenditure and one third revenue measures.
- The adjustment will weigh on domestic demand, but its overall effect will be mitigated by the economy's high propensity to import and by the positive impact of budgetary adjustments on competitiveness and confidence.
- Ireland is a small, open economy in which long-term sustainable growth depends on the health of its internationally trading sectors.
- The conditions for sustainable export-led growth are in place - good infrastructure, high-quality human capital, a favourable taxation environment and available credit for viable businesses.
- The Plan sets out policies to assist a resumption of output and employment growth, including structural reforms to enhance labour market flexibility and cost competitiveness.
- Export-led growth will foster recovery in the domestically trading sectors.
- Growth in GDP is expected to bring the unemployment rate down below 10% by 2014.
- The balance of payments (BoP) is expected to return to surplus in 2011 and the surplus will steadily increase over the following three years. This means that the economy as a whole will no longer be borrowing from the rest of the world.

1.1 The Economy in 2010

1.1.1 Current Position

The economy is emerging from recession. The level of GDP in 2010 will be some 11% below and the level of GNP some 15% below their respective levels of 2007 in real terms. Employment has fallen by about 13% from its peak of 2007 while the unemployment rate has risen from 4.6% to 13.5%. A downturn of this size is without precedent in Ireland's recorded economic history and has few modern parallels at an international level. It follows annual average growth of 7.3% and 6.6% in GDP and GNP respectively, and a cumulative increase of over 900,000 of the numbers at work, between 1994 and 2007.

The recession was due in part to the effects of a steep economic downturn in our main trading partners and a deep global financial crisis. But it was exacerbated by the collapse of the domestic property market and construction industry and the associated banking crisis at home. As such, the

severity of the recession may be attributed to the combination of excessive credit expansion, rapid property price inflation and disproportionate growth in construction output in the earlier 2000s.

The crisis has had a severe impact on the public finances. Tax receipts in 2010 will be around 33% lower than in 2007, the steepness of the fall reflecting the over-dependence on property and construction-related revenue sources during the boom years. At the same time, net current spending has continued to rise because of the upward pressure exerted by a much increased Live Register, a mounting debt interest burden and falling receipts from sources such as PRSI. As a result, the public finances have deteriorated rapidly and a structural gap between spending and revenue has opened up which will not be closed by a cyclical recovery in the economy (see Annex 1).

Recent data suggest that economic recovery is slowly taking shape. It is now expected that GDP will record a very small increase this year on the back of strong export growth. Exports in turn are being driven by improvements in competitiveness and a strengthening of international markets. Conditions in the labour market are also beginning to stabilise as indicated by the flattening of the unemployment rate and recent declines in the monthly Live Register. However, domestic demand remains weak as households and businesses continue to repair their balance sheets following a period of excessive debt accumulation.

1.1.2 Budgetary Outlook for 2010

Introduction

In early November, the Department of Finance published an Information Note on the economic and budgetary outlook, based on detailed technical analysis and containing an assessment of future economic conditions. Further information on the economic and budgetary outlook can be found in that Note which is available on the Department's website at www.finance.gov.ie. Additional economic data, including a comparison of the Department's forecasts with those of other organisations, a discussion of risks, and sensitivity analysis associated with this Plan are set out in Annex 2.

The Budget Deficit

The latest Exchequer figures indicate that the Government will achieve its objective of stabilising the underlying budget deficit in 2010. Net voted current expenditure was €37.2 billion for the period January to October 2010, 2.7% below profile. Tax receipts for the same period amounted to €24.7 billion or 1% above profile. November will be a key month for tax receipts. However, tax revenue for the year as a whole is currently expected to amount to €31.5 billion, some €450 million above the level forecast in last December's Budget.

Taking account of the likely evolution of Government spending in the final months of the year, and excluding the impact of the bank support measures, the General Government deficit in 2010 is now expected to be 11.7% of GDP, in line with the Budget 2010 target of 11.6%.

Public Debt

Due to the strong performance of the economy through much of the 1990s and early 2000s, debt ratios fell dramatically. As a result, the General Government Gross Debt to GDP ratio had fallen to just 25% by end-2007. The underlying position was even stronger at that point: the net debt to GDP ratio was just 14%.

By end-2009 however, reflecting the large deficits recorded in the intervening period, and other factors, General Government Gross Debt had reached 66% of GDP. It is currently estimated that the ratio will be 95% of GDP at end-2010. The main reason for the very large increase this year is that the capital support – some €31 billion – being provided to a number of institutions within the banking sector in 2010 is classified within the General Government Gross Debt measure. When account is taken of the value of assets in the National Pensions Reserve Fund (NPRF) and of Exchequer cash balances, the position is a good deal more favourable. The net debt measure that results from these adjustments is estimated at 69% of GDP at the end of 2010.

1.2 Budgetary Adjustment

1.2.1 *Rationale for Adjustment*

In money terms, the gap between Government receipts and spending will come to almost €19 billion in 2010. This gap simply must be closed. Government has already taken significant actions to prevent the gap from widening. Table 1.1 shows the adjustments to expenditure and revenue, amounting to a cumulative €14.6 billion, already implemented between July 2008 and Budget 2010 in pursuit of this objective.

Despite the scale of the adjustment, a very large and unsustainable gap remains between spending and revenues, which is filled by borrowing.

Table 1.1 Budgetary Adjustments since mid-2008 – planned budgetary impact upon 2010	
	€ billion
July 2008	
Expenditure Adjustments	1.0
Budget 2009 (October 2008)	
Revenue raising measures	2.0
February 2009*	
Expenditure Adjustments	2.1
Supplementary Budget (April 2009)	
Revenue-raising & expenditure-reducing measures	5.4
Budget 2010 (December 2009)	
Expenditure-reducing & minor revenue-raising measures	4.1
Total	€14.6bn

*Postponement of the pay increases contained in the 'Towards 2016' agreement generated another €1 billion in full year savings

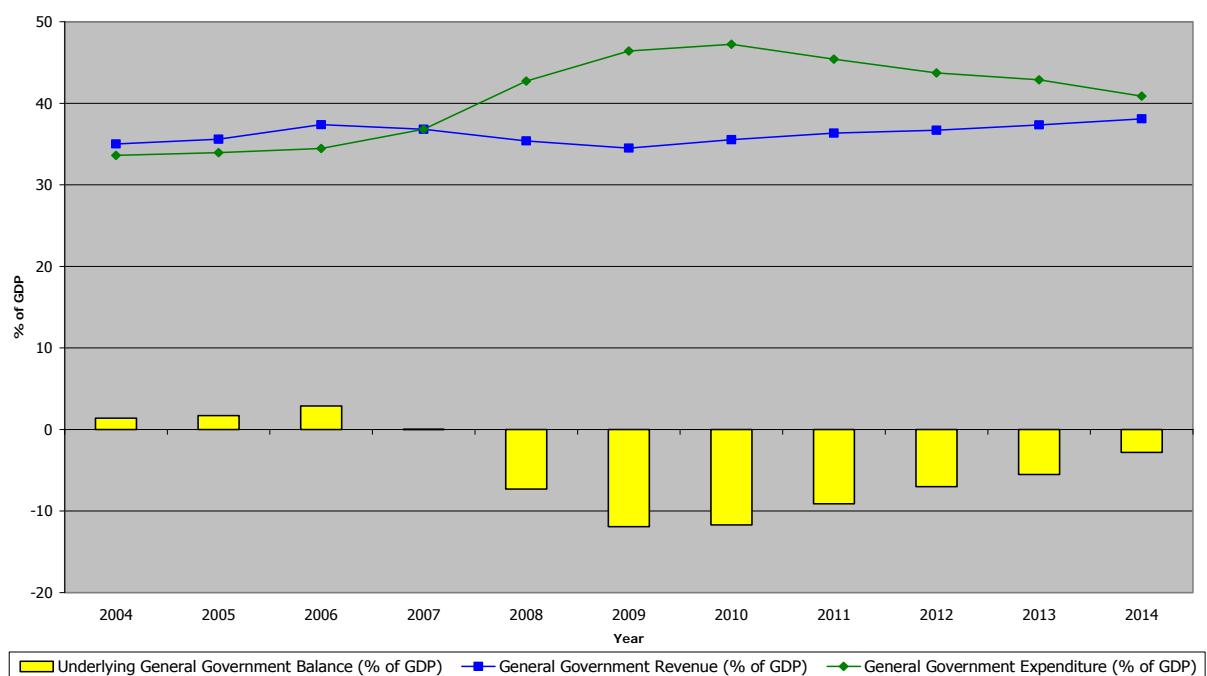
The current level of borrowing is unsustainable. Unless it is reduced, the burden of debt service will absorb a rapidly increasing proportion of tax revenue, even assuming no upward pressure on interest

rates. More pertinently, as recent developments in the international bond markets have shown, persisting with the current scale of borrowing will result in interest rates remaining at unaffordable levels. Moving towards a balanced budget therefore is a prerequisite for future economic growth. Tackling the deficit now is essential in order to engender international confidence in our ability to meet our commitments.

1.2.2 Scale of adjustment required

Ireland's membership of the eurozone obliges us to adhere to the Stability and Growth Pact and bring the General Government deficit back below 3% of GDP. Budget 2010 assumed an adjustment package of €7.5 billion over a four-year period would be required to reach this target by 2014, the target year agreed with our European partners. It is now estimated that an adjustment of some €15 billion will be necessary to reach this target.

Figure 1.1 Public Finances 2004-2014



Reasons for the increase in the size of the budgetary adjustment required

- The economy is smaller, reflecting CSO revisions to the level of GDP in 2009 and previous years.
- The repair of household and company balance sheets after the damage caused by the bursting of the property bubble will dampen consumer and investment spending to a greater extent than previously thought.
- The level of prices in the economy is now forecast to rise more sluggishly than previously expected as economic activity generally is more muted.
- The impact of the Promissory Notes issued to Anglo Irish Bank, INBS and EBS, means that in order to achieve the budgetary targets by 2014 compensatory measures must be taken over the period 2011 to 2014. These costs will amount to an estimated €2.4 billion in 2014 and, if not addressed, would add about 1.3% to the deficit figure in that year.
- All of these factors suggest that the outlook for growth, both real and nominal, is less favourable than a year ago. This means having to adjust more and in so doing there is an additional negative impact on the economy.

1.2.3 The Composition of the Budgetary Adjustment

It is clear that an adjustment of the magnitude required cannot be achieved by exclusive reliance on either tax increases or expenditure cuts. If taxes were raised by €15 billion over the next four years, the burden of taxation would increase to the point where competitiveness was hugely impaired and the economy's capacity to generate growth in output and employment seriously damaged. Conversely, if the entire burden of the €15 billion reduction were to fall on Government spending, the impact on public services and social welfare provision would be unacceptable.

It follows that the adjustments to be made must comprise a mix of revenue-raising and expenditure-reducing measures. In determining the appropriate balance between the two, the Government has been guided by the lessons of our past as well as the experience of other countries that have found themselves in similar circumstances. The international evidence, analysed by organisations such as the IMF, the EU Commission and the OECD, suggests that budgetary adjustments are more successful in reducing deficits and stabilising debt ratios when they rely more on reducing expenditure than increasing taxes.

This is consistent with our own experience of the late 1980s. The unsuccessful attempts at restoring order to the public finances in the early part of that decade leaned heavily on tax increases, while the successful budgetary adjustment of the late 1980s relied more on controlling expenditure and, insofar as it included tax measures, concentrated on widening the base rather than increasing rates of tax.

Of the €14.6 billion of budgetary adjustments that have already been undertaken since 2008 just under two-thirds have fallen on the expenditure side with the remainder comprising revenue-raising measures. Similar proportions will apply to the adjustments planned for the next four years: of the €15 billion overall adjustment to be made, €10 billion will be composed of expenditure reductions and €5 billion will comprise revenue-raising measures. Drawing on the experience of the 1980s, the proposed revenue-raising measures will concentrate on broadening the base as part of the reform of the tax system that was signalled in Budget 2010.

The effect of the adjustment will be to raise the overall ratio of tax (including receipts from PRSI, the Health Levy and the National Training Fund Levy) to GDP by about 3% points between 2010 and 2014. This will still leave the ratio slightly below the level it was at in the late 1990s, a period during which the economy last experienced balanced export-led growth.

Table 1.2 below shows the General Government Deficits in each of the years 2011-2014, arising out of an overall adjustment package of €15 billion. Achieving these budget targets is predicated on implementing the expenditure and taxation adjustments set out later in this document. Chapters 3 to 5 detail the required current and capital expenditure adjustments on a sector by sector basis. Chapter 6 sets out the individual revenue-raising measures which are necessary to generate an additional €5 billion in revenue.

Table 1.2 – Forecast General Government Deficits and end-year Gross Debt Levels				
	2011	2012	2013	2014
General Government Deficit (% of GDP)	9.1%	7.0%	5.5%	2.8%
Total Consolidation² (Full-Year Impacts)	€6.0bn	€3.6bn	€3.1bn	€3.1bn
▪ <i>Expenditure</i>	€3.9bn	€2.1bn	€2.0bn	€2.0bn
○ <i>Current</i>	€2.1bn	€1.7bn	€1.6bn	€1.6bn
○ <i>Capital</i>	€1.8bn	€0.4bn	€0.4bn	€0.4bn
▪ <i>Taxation</i>	€1.4bn	€1.5bn	€1.1bn	€1.1bn
▪ <i>Other</i>	€0.7bn			
General Government Gross Debt (% of GDP)	100%	101%	102%	100%

Rounding may affect totals

Implementing a package of budgetary adjustments totalling €15 billion over the next four years in the manner outlined above and a gradual unwinding of Exchequer cash balances is expected to result in the General Government Gross Debt peaking in 2013 at 102% of GDP before falling to 100% of GDP by 2014.

The stabilisation and subsequent reduction of the ratio of debt to GDP is dependent, among other things, on the growth rate of nominal GDP and the average interest rate on the debt. The sensitivity of the ratio to these variables is explored in Annex 3.

1.3 Achieving Economic Recovery

1.3.1 Growth in an Open Regional Economy

Ireland is an open regional economy. Its openness is most obvious in terms of the importance of international trade: exports and imports of goods and services are equal to 175% of GDP. But there are other dimensions of Ireland's openness that are no less significant. One is its dependence on international capital flows, including flows of foreign direct investment from abroad. Another is the elasticity of its labour supply: the capacity for its labour force to be augmented by immigration and depleted by emigration.

Ireland's openness means that the economy here interacts widely and deeply with the rest of the world and is sensitive to changes in world economic conditions, while its size means that the domestic market is too small to provide the basis for long run sustainable growth. Long term growth in a small open economy therefore is a function of the export base, the collection of enterprises that are involved in the production of goods and services for international markets.

² Total consolidation sums to more than €15 billion in Table 1.2 due to inclusion of non-recurring once-off items that impact in 2011 only. The full year impacts of expenditure and revenue measures are taken into account in the figures.

The enterprises that make up these internationally trading sectors generate output and employment directly, but they also generate output and employment indirectly in Ireland through their demand for buildings, machinery, components, raw materials and a wide range of service inputs. On top of that, the internationally trading sector together with the local firms that supply it, create a multiplier effect throughout the wider economy, as the people employed in these sectors spend their wages and salaries.

The vitality and dynamism of the Irish economy therefore depends ultimately on the vitality and dynamism of its internationally trading sector. This, in turn, depends on the competitiveness of the enterprises that go to make up the sector, that is, on their ability to win, retain and expand their share of the international markets which they serve. It also depends on Ireland's attractiveness as a location for the establishment of new exporting activities.

Long-term sustainable growth in the Irish economy is export-led. This is not to say that domestic demand is unimportant. On the contrary, balanced economic growth is attained when consumption and investment, as well as exports, are expanding at a healthy pace. Indeed, strong gains in employment typically require solid growth in domestic demand. This is because the sectors that serve domestic demand, like retailing and construction, tend to be more labour intensive than the exporting sectors. There are notable exceptions to this pattern. Tourism, for example, is an important exporting sector that is relatively labour intensive.

In their recent analysis of the causes of the swift reversal of our economic fortunes, Klaus Regling and Max Watson³ conclude that in the period leading up to the current crisis, the share of construction sector in the economy became excessive and as our competitiveness deteriorated significantly, Ireland lost market shares in international trade. At the height of the building boom in 2007, the construction sector directly accounted for 13% of total employment, compared with an average of just over 7% for the 1990s. The appetite of a rampant building industry for labour and other resources put upward pressure on the economy's cost structure and contributed to the deterioration in the competitiveness of the internationally trading sectors.

The Irish economy did enjoy sustained balanced export-led growth as recently as the 1990s. Between 1993 and 2000, exports expanded at almost 18% per annum, driving average annual GDP growth of 9%, a cumulative increase of half-a-million people in employment, a cumulative rise in living standards of about 80%, and all in the context of maintaining a healthy balance of payments position and achieving a substantial government budget surplus.

The formula for achieving the kind of balanced sustainable growth in output and employment that is appropriate to a small open economy, therefore, is not elusive. We discovered and applied that formula in the 1990s and we can do so again.

³ A Preliminary Report on the Sources of Ireland's Banking Crisis by Klaus Regling and Max Watson – Published May 2010.

1.3.2 Economic Policy Principles

Although Government has only a marginal presence in the production of internationally traded goods and services, it plays a vital part in creating the conditions in which the sector can grow and prosper. Equally important, Government is responsible for creating an environment that makes Ireland an attractive place in which to live and work.

The most important of these conditions and the one for which the Government has the clearest and most direct responsibility is sound public finances. Unsustainable public finances undermine the framework for economic prosperity through at least three channels: (i) the upward pressure on interest rates and the consequent increase in the price of credit; (ii) the uncertainty created about the future course of taxes and the continued provision of essential public services, and (iii) the reputational damage to the country and its institutions. The restoration of sound public finances must be the cornerstone of any economic plan.

The measures taken to restore sound public finances must observe certain principles and must have regard to the nature of the Irish economy. A key principle is that the measures be fair and be seen to be fair in order to maintain the highest degree of social cohesion. In deciding on the measures to be taken to restore sustainability to the public finances, the government has attempted to spread the burden of adjustment as equitably as possible.

Over the past two years, the combination of tax and social welfare changes has reflected that spirit of fairness. Analysis of the distributive impact⁴ shows that the net impact of these changes has been progressive, with higher income groups carrying a larger burden than those on modest incomes. In real terms, the reduction in the cost of living has also helped to maintain living standards.

A number of other considerations have informed the Government's approach to framing the budgetary measures and the broader economic policy initiatives detailed later in this Plan:

- The need to boost competitiveness. This has, for example, influenced the composition of budgetary adjustment as between spending and revenue-raising and the emphasis in raising revenue on widening the base rather than raising tax rates.
- The need to enhance the economy's productive capacity. The government has sought to make the bulk of the necessary spending reductions on the current side. In doing so it has ensured that sufficient funds are available to press ahead with key infrastructural projects and to maintain high levels of spending on education.
- The need to take a long-term view. At the core of our fiscal problem is a large structural deficit, the measures to eliminate which have to be structural in nature. These measures must be permanent in their impact and selected on the grounds of their appropriateness over the medium to long run. Charting our way out of our current difficulties requires long-term

⁴ Carried out by the Social Inclusion Unit in the then Department of Social and Family Affairs.

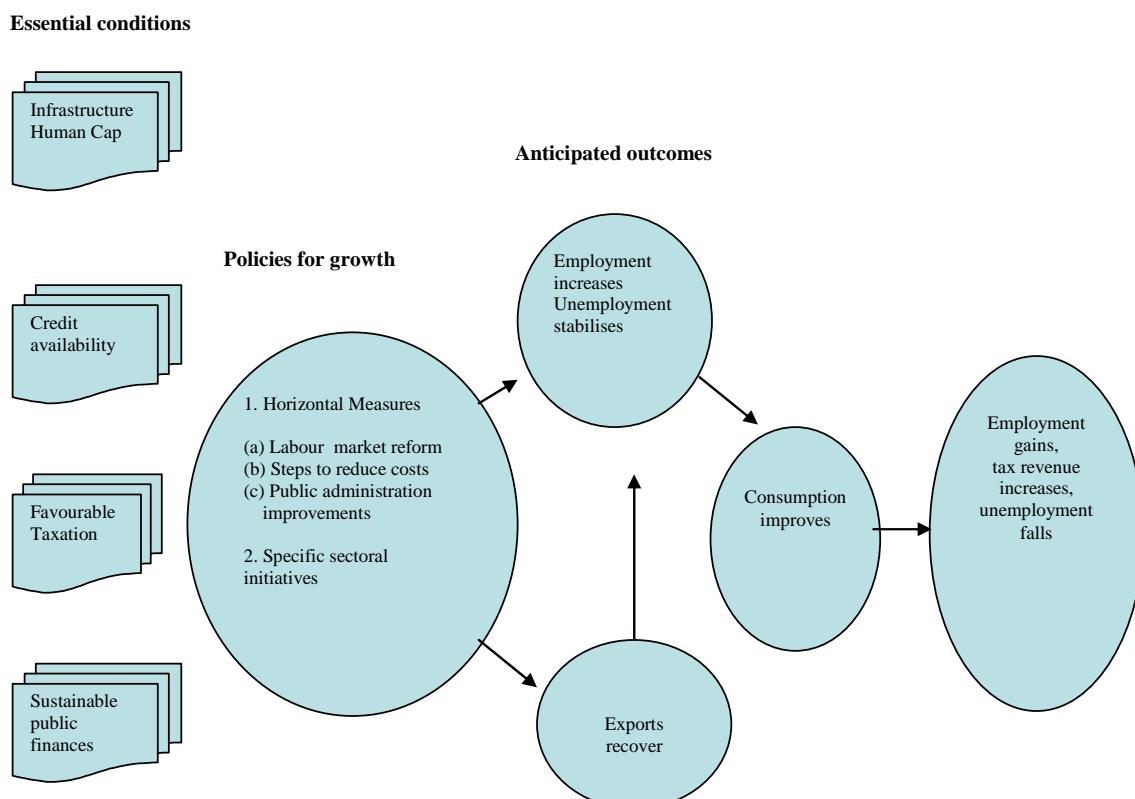
planning. The proposals for reform of the budgetary process, outlined in Chapter 3, are intended to create a framework in which fiscal policy decisions are informed by a medium to long-term perspective.

- The need for credibility. This Plan must be credible, both to Irish citizens and to international markets. To that end, the Plan is based on a set of economic forecasts which the Government believes to be prudent, and sets out the policy measures which it is proposed to take at a level of detail designed to dispel uncertainty to the greatest degree possible.

1.3.3 Strategy for growth

Figure 1.2 illustrates the anticipated path to economic recovery set out in this chapter. The process of recovery is founded on a number of essential conditions – which are either in place, or are being pursued actively - coupled with a range of specific policy actions detailed in Chapter 2. These measures will assist export recovery through enhanced competitiveness and sector-specific initiatives. Export growth will in turn deliver high value employment and act to stimulate the domestically trading sectors of the economy. The measures contained in Chapter 2 will also directly assist in job creation in the local economy by removing barriers to employment and disincentives to work. These developments will in turn boost consumption and, over time, reduce unemployment and lead to further employment gains.

Figure 1.2 Summary Steps to Economic Recovery



Restoring competitiveness and retuning sectoral policy to grow exports and assist locally trading firms is the necessary first step on the path to economic recovery. This is Government's core strategy for tackling unemployment.

1.3.4 Essential Conditions for Growth

Our experience shows that economic growth and sustainable jobs are generated by the private sector in the main. But Government plays an important role in creating the framework conditions to enable growth. The budgetary adjustment measures set out in this Plan can deliver sustainable public finances. Other essential inputs from Government include:

- the provision of appropriate economic and social infrastructure;
- investment in human capital;
- ensuring adequate credit availability; and
- tax policies which are favourable to entrepreneurship, investment and work.

Across these areas, conditions for growth are either already in place, or policies to achieve them are being pursued.

Essential Conditions for Growth

Physical infrastructure

Improvements to our stock of economic and social infrastructure over the past decade or so are a visible legacy of the economic expansion of that period. In the years between 1997 and 2007 annual public capital allocations were quadrupled. This investment expanded capacity across a range of sectors and addressed the infrastructure deficit that had previously constrained the Irish economy.

The current stock of infrastructure, which will be augmented by a substantial ongoing programme of public investment over the next four years, leaves the economy well-equipped to return to export-led growth.

Capital investment will continue to support employment by providing a significant level of direct job supports to IDA Ireland and Enterprise Ireland. These supports will be maintained so that the Government will offer considerable direct assistance to the enterprise sector alongside measures to improve competitiveness.

Available human capital

As with the stock of physical infrastructure, the quality of Ireland's human capital puts us in a strong position for a return to economic growth.

The country continues to have a skilled and flexible labour force whose educational profile displays a number of positive characteristics. The 25-34 year old age cohort, for example, has a higher level of formal qualification than the OECD average, while the proportion of the population aged 20-24 with at least an upper second-level education is the highest in the EU15 (see figure 1.3)

Amongst those who have become unemployed a large number have significant levels of skill and experience and a history of achievement across a range of sectors.

Credit availability for business

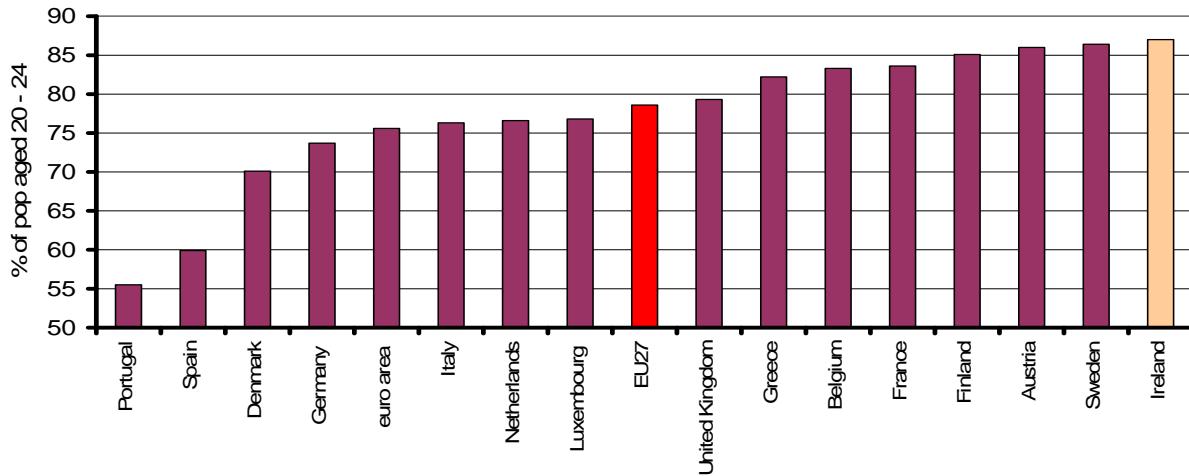
An overriding objective of the Government's banking policy is to ensure that viable businesses, especially Small and Medium Enterprises (SMEs), can access the credit they need. To this end a Code of Conduct on SME Lending was introduced for the first time last year. The Code requires banks to deal fairly and transparently with their business customers. In addition, the Credit Review Office (CRO), set up under the NAMA legislation, provides a review mechanism for SMEs who have had credit refused, withdrawn, or offered on unreasonable conditions. In his latest quarterly report, Mr. John Trethowan of the CRO notes that the lending situation for SMEs is improving and that the recapitalisation strategy for the two largest banks (Bank of Ireland and Allied Irish Bank) is achieving its objective.

Favourable taxation

The tax burden in Ireland is relatively low and will remain so even after the revenue-raising measures contained in this Plan have been implemented.

A key feature of the tax system is the 12½% corporation tax regime which represents an essential pillar of enterprise policy. Other important aspects of the corporation tax framework include: the R&D tax credit; the holding company tax regime and Ireland's rapidly expanding network of double taxation agreements.

Figure 1.3 Proportion of population with at least upper second level education



Source: Eurostat

1.3.5 Retuning Policies for Growth

Actions have been taken on all the essential conditions for growth but a number of critical reforms will further boost economic activity. These can be broadly categorised as follows:

- Labour market reforms to remove barriers to employment and disincentives to work;
- Reforms to improve the non-labour elements of cost competitiveness; and
- Supportive sectoral policies to assist recovery across the enterprise base.

These structural reforms to bolster the private sector are presented in detail in Chapter 2. Over the medium-term they will be complemented by reforms to the operation of the public service, discussed in Chapter 4. The associated policy actions represent a coherent Government strategy for creating the conditions that will foster the resumption of growth in output and employment.

1.4 The Economic Outlook, 2011-2014

1.4.1 Output and Employment

After two years of extremely sharp declines in output, the Irish economy, as noted above, is expected broadly to stabilise this year before expanding over the period 2011 to 2014. Consistent with the typical recovery path in a small open economy, the stabilisation and initial strengthening will be primarily driven by a recovery in exports. The recent performance of exports has been encouraging and it is now estimated that they will grow by about 6¼% in real terms in 2010. In 2011, there may be some slowdown, reflecting the moderation of the pace of recovery in our main trading partners,

but taking the 2011-2014 period as a whole, exports can be expected to increase at a healthy pace as the competitiveness of Irish producers improves further and demand continues to grow in our overseas markets.

Table 1.3 Medium term economic outlook				
(% change unless otherwise stated)	2011	2012	2013	2014
GDP real	1 $\frac{3}{4}$	3 $\frac{1}{4}$	3	2 $\frac{3}{4}$
GDP level ^ (€m)	161,200	168,100	175,400	183,500
GNP real	1	2 $\frac{1}{2}$	2 $\frac{1}{2}$	2 $\frac{1}{2}$
GNP level ^ (€m)	127,900	132,500	137,600	143,400
<i>components of real GDP</i>				
Domestic demand				
- consumption	0	1	1 $\frac{1}{2}$	1 $\frac{3}{4}$
- government	-3	-2	-2 $\frac{1}{4}$	-2
- investment	-6	5 $\frac{1}{4}$	5	5 $\frac{1}{4}$
Trade and external account				
- exports	5	5	4 $\frac{1}{2}$	4
- imports	2 $\frac{3}{4}$	3	3 $\frac{1}{4}$	3
- BOP current account (% GNP)	1/4	1 $\frac{1}{2}$	2 $\frac{1}{2}$	3 $\frac{1}{2}$
<i>price developments</i>				
HICP	3/4	1	1 $\frac{3}{4}$	1 $\frac{3}{4}$
GDP deflator	3/4	1	1 $\frac{1}{4}$	1 $\frac{1}{2}$
<i>labour market</i>				
Employment	-1/4	1 $\frac{1}{4}$	1 $\frac{1}{2}$	1 $\frac{3}{4}$
Unemployment (%)	13 $\frac{1}{4}$	12	11	9 $\frac{3}{4}$

Source: Department of Finance forecast

^ Figures are rounded to the nearest €100 million

As a healthy export performance filters through to investment and consumption, the recovery in economic activity should become more broadly-based. However, domestic demand is likely to respond sluggishly. Household finances have been significantly affected by house and other asset price declines in recent years and, while the unemployment rate is now stabilising, it is doing so at a high level and will take some time to decline. Households have entered a period of debt reduction. This in turn has reduced the amount of disposable income available for consumption and will continue to do so for some time to come. In these circumstances, the household savings rate will likely remain above its historical average, although it is expected to fall over the period of the Plan, as the crisis recedes, consumer confidence returns and labour market conditions improve.

In these circumstances, real consumer spending is expected to be flat in 2011 before expanding modestly, at an annual average rate of around 1 $\frac{1}{2}$ % in the period 2012 to 2014. Some of the factors restraining consumer spending – in particular the need to repair balance sheets – are also likely to restrain investment spending by firms in the period ahead. Taken together with the outlook for public capital spending, this indicates that overall investment spending will provide limited support to domestic demand. A 6% fall is expected in 2011, followed by average annual growth of about 5% over the following three years.

Real GDP is forecast to increase by an average of almost 2¾% in the years 2011 to 2014, with real GNP growing by an average of just over 2% over this period. Growth in 2011 however will be considerably below the average for the period as a whole. This moderate expansion in output is expected to be accompanied by the resumption of employment growth, starting in 2012 and averaging about 1½% a year between 2012 and 2014, generating a cumulative increase of about 90,000 over this period. This is consistent with a steady decline in the unemployment rate which is expected to have fallen below 10% by 2014.

Reflecting the moderate pace of output growth, the amount of spare capacity in the economy and the likelihood that external pressures on prices will be modest, low rates of inflation are projected. Consumer price inflation should be contained at less than 1% in 2011 and is forecast to average 1½% in the years 2012 through 2014. The GDP deflator, which provides the most comprehensive measure of inflation in the economy, is expected to increase at a somewhat slower rate. Inflation, by either measure, is expected to be lower than in our main trading partners over the period of the Plan, reflecting and assisting the process of competitiveness improvement.

This economic outlook summarised above takes account of the €15 billion budgetary adjustment package planned for 2011-2014. It also takes account of the favourable impact on output and employment expected to accrue from the proposed structural reforms to bolster labour market flexibility and cost competitiveness contained in Chapter 2.

1.4.2 The Impact of Fiscal Consolidation in an Open Economy

Budgetary adjustment will clearly have a negative impact on household disposable income, thereby lowering personal consumption. However, the impact of the adjustment on consumption is unlikely to be one-for-one. This reflects the current elevated level of household savings. Figures from the Central Statistics Office (CSO) put the savings rate at over 12% in 2009, and Department of Finance estimates point to a broadly similar rate for this year. Households have increased their savings for a number of reasons: uncertainty regarding future income prospects has motivated an increase in precautionary savings while the decline in net household wealth (or more precisely the ratio of net wealth to disposable income) has prompted debt deleveraging within the household sector, a phenomenon which is expected to decline over the period of the Plan.

Budgetary adjustment can potentially play a positive role in reducing precautionary savings by creating greater certainty about the prospects for household disposable income. In particular, permanent, targeted and well-designed budgetary adjustment measures can reasonably be expected to have a favourable effect on confidence, so that the impact on consumer spending of lower disposable income may be partly offset by a decline in the savings rate. In relation to specific measures, as noted earlier, the available evidence suggests that reductions in current spending have a smaller negative impact on economic activity than cuts in productive capital spending or tax increases.

The available evidence also indicates that, when taxes need to be raised, measures that broaden the tax base are preferable to increases in tax rates.

The openness of the Irish economy must also be borne in mind in assessing the effect of budgetary adjustment. In the first instance, the import content of spending in Ireland is relatively high. In other words, we import a large share of what we consume. Thus, while domestic demand will clearly decline because of the budgetary adjustments that need to be made, the consequent decline in imports will mean that the impact on GDP will be significantly less than it would otherwise be.

At the same time, the budgetary adjustment will contribute to improving the economy's competitiveness by putting downward pressure on the domestic cost base. This will have a positive effect on export performance which will provide some measure of offset to the dampening effect of fiscal correction on overall economic activity.

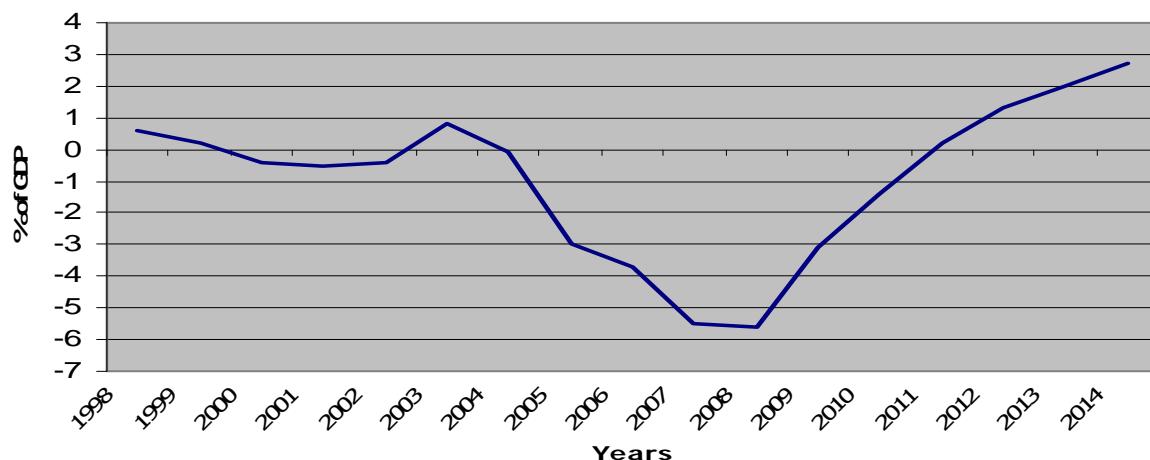
1.4.3 Savings, the Balance of Payments and the Banking System

The current account of the balance of payments is a measure of the extent to which the economy as a whole is lending to or borrowing from the rest of the world. An important aspect of the behaviour of the Irish economy over the past few years relates to the balance of payments. Since 2008 there has been a sharp fall in the balance of payments current account deficit, which amounted to almost 6% of GDP in 2008, but which is estimated to have declined to 1.4% of GDP in 2010. What this signifies is a major reduction in the rate at which Ireland (public and private sectors together) has been borrowing from abroad.

Given an underlying government budget deficit of 11.7% of GDP, the small current account deficit in 2010 indicates that the private sector is now running a very large financial surplus, equivalent to over 10% of GDP. This surplus reflects the combination of the steep fall in investment and the sharp increase in savings that has occurred in the recession.

The increase in savings is especially evident in the household sector where the savings rate, according to the CSO, rose from less than 4% in 2008 to over 12% in 2009. This increase in savings has been used to rebuild household balance sheets. In part this has been achieved by the repayment of debt. Already, the value of outstanding loans to households has been reduced by about 10% from its January 2008 peak of €154 billion to €139 billion in September 2010.

Figure 1.4 Balance of Payments Current Account (% of GDP)



The forecasts underpinning this Plan envisage the current account of the balance of payments recording a small surplus in 2011, and see that surplus growing steadily over the period to 2014, by which time it is expected to reach 2.7% of GDP. The budgetary programme is targeting a decline in the Government's budget deficit from 9.1% to 2.8% of GDP over the same period. This combination of current account surpluses and substantial (though declining) budget deficits implies the continuation of a large private sector financial surplus throughout the period of the Plan.

Much of this accumulation of financial surplus by the private sector will take the form of increased deposits with and reduced borrowing from domestic banks. The result will be a very substantial fall in the loan-to-deposit ratio of the domestic banking system and a corresponding reduction in the domestic banks' reliance on external sources of funding.

Chapter 2 Strategy for Competitiveness, Growth and Employment

Key Messages

- Export led growth will fuel domestic recovery.
- Policy will foster the considerable growth potential of the Irish economy.
- Cost competitiveness will be improved through a series of specific measures in the waste, energy, transport, telecommunications, professional services and public administration sectors.
- Barriers to employment creation will be removed.
 - The level of the National Minimum Wage will be reduced by €1 an hour.
 - The Minister for Enterprise, Trade and Innovation will complete a review to eliminate anomalies in the framework REA and ERO agreements within three months.
- Welfare and labour market policies will be overhauled so that work is rewarded and those seeking work have a pathway to work, education and training.

2.1 Overview - the Strategy for Economic Recovery

Competitiveness is the key to a return to economic growth and a resumption of sustainable employment creation. We have made progress over the last two years. But more needs to be done. This means reducing costs and improving productivity in all sectors.

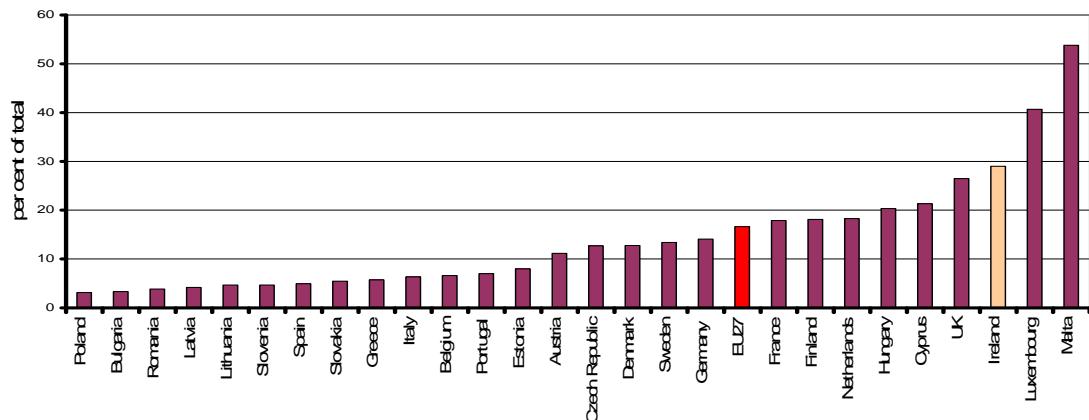
The job of Government is to support the private sector by removing structural impediments to competitiveness and employment creation and securing the conditions for growth. But the Government must also pursue appropriate sectoral policies to foster export growth and a recovery of domestic demand. This Chapter sets out the key reforms in each of these important areas.

For a regional, open economy such as ours, sustained export growth will be a critical step on the path to economic recovery. Labour market reform and competitiveness measures in this Plan will assist this process and will help foster employment creation in domestically trading sectors such as retail and hospitality.

The prospects for a return to enterprise-led growth are improved by the modern nature of Ireland's export base as illustrated in Figure 2.1. The high proportion of exports from high-tech sectors⁵ indicates that the Irish economy has already established a strong base which can act as a platform for further advancement to a more knowledge intensive period of growth.

⁵ It should be noted that high-tech sectors may include manufacturing activities with low tech processes. Nonetheless the graph is a useful indicator of the comparative modernity of Ireland's export base.

Figure 2.1 High-tech exports as a proportion of total



Source: Eurostat

Enterprise Policy – Driving the Smart Economy Agenda

Alongside the sector specific policy supports set out in section 2.5, a number of cross-cutting issues relevant to enterprise policy warrant some discussion.

This Plan builds on, and is consistent with, *Building Ireland's Smart Economy*, the framework for sustainable economic recovery published in December 2008. This framework identified five action areas as the basis for the Government's response to the crisis:

- securing the enterprise economy and restoring competitiveness;
- building the Ideas Economy;
- enhancing the environment and securing energy supplies;
- investing in critical infrastructure; and
- providing efficient and effective public services and smart regulation.

It placed particular emphasis on increasing productivity across all sectors of the economy as the basis for sustainable improvements in living standards. It also stressed the role of knowledge and innovation in driving productivity.

The Government has acted in all these areas to tackle short-term difficulties while laying the basis for future recovery. It has

- introduced supports for business, through short term measures such as the Enterprise Stabilisation Fund and the Employment Subsidy Scheme, while ensuring large gains in international competitiveness;
- begun to re-position Ireland as a Global Innovation Hub based on the work of the Innovation Taskforce, particularly through the establishment of Innovation Fund Ireland;
- sustained high levels of capital investment to support economic activity during the last two years, completed the inter-urban motorways and delivered new projects at reduced cost; and
- provided funding for R&D and commercialisation and for renewable energy including ocean energy and biomass.

The Government recently launched a new strategy – Trading and Investing in a Smart Economy – to integrate the promotion of overseas trade, tourism and investment. This strategy sets out cross-sectoral priorities and targets, and a series of recommended actions that will ensure our trade, tourism and investment sectors are well positioned to respond effectively to emerging opportunities as the global economy recovers. The strategy focuses on specific sectors and markets and is expected to deliver 150,000 direct and 150,000 indirect new jobs. We have also set ambitious targets for new FDI investments, tourist numbers and exports.

The selected sectors include services, tourism, food, education, life sciences, software, Next Generation Network-enabled sectors, green technology, construction and the built environment, creativity and design, and technologies for an ageing population ('silver technologies').

Britain and the United States will continue to be our key markets. But there is considerable potential to expand business with our Euro area partners, as well as in new and high potential growth markets such as Brazil, China, India, Russia, Japan, and the Gulf States.

Positioning Ireland's brand and reputation in new growth markets and reinforcing positive messages about our brand and reputation in existing markets will support broadly based export-led economic recovery.

2.2 Restoring Cost Competitiveness

Data on prices, costs and productivity point to a sustained improvement in competitiveness over 2009 and 2010. The fall in the euro exchange rate against the dollar and sterling in the first half of 2010, and lower inflation in Ireland has assisted export performance⁶. But improvements have been slower to materialise in some areas, principally in the locally trading sector of the economy. Table 2.1 shows our ranking in a selection of key competitiveness indicators.

Table 2.1 Selected cost competitiveness indicators

<i>Cost category</i>	<i>Rank among countries benchmarked</i>
Large energy user prices	6 th / 14
Waste disposal costs	9 th / 9
Water costs for industrial users	10 th / 16
Mobile telephone costs (high usage)	5 th / 13
Broadband low speeds (< 2mbps)	6 th / 24
Broadband medium speeds (2-12mbps)	11 th / 29
Broadband high speeds (12-32mbps)	10 th / 29
Prime industrial rental	11 th / 13
Prime office space rental	8 th / 13

Source: National Competitiveness Council, Eurostat and OECD

⁶ Central Bank (2010) *Quarterly Economic Bulletin*. Q4.

A number of areas require further action in order to boost competitiveness.

2.2.1 Waste, Energy and Transport

There has been a significant reduction in the cost of electricity for large users. For large energy users we are sixth cheapest out of 14 countries benchmarked. For SMEs we are now close to the EU average. A rebate of network charges to large energy users, combined with falling fuel prices and the development of renewable energy assisted this process. The Energy Regulator has taken steps to achieve efficiencies in network investment and operations. This has been matched by Government policy actions including the introduction this year of a carbon windfall levy on generators. The full opening up to competition of the supply and generation markets can be expected to have a positive impact on prices. Government will also take further actions.

Action Points

- The Commission for Energy Regulation will continue to impose rigorous efficiency targets on the ESB, Bord Gáis and Eirgrid to drive efficiencies in the energy sector.
- Capital investment programmes by the utility companies will be commensurate with the infrastructure needs and energy demand of the Irish economy avoiding excess capacity and extra cost.
- The National Energy Efficiency Action Plan will be implemented in order to achieve a national energy saving of 20% by 2020⁷ including measures to assist SMEs to lower electricity costs.

When it comes to waste management costs and treatment options, Ireland needs to improve its performance.

Action Points

- Major waste infrastructure will continue to be developed primarily by the private sector while public investment in recycling infrastructure will be maintained - both elements will expand capacity and assist competitiveness.
- Levies will be used to drive waste modernisation in accordance with a sustainable waste hierarchy, ensure compliance with EU legislation and create a revenue stream for investment in support of waste policy objectives and enforcement.
- Government will ensure greater competition for public transport routes following the establishment of the National Transport Authority. This will have further positive effects on competitiveness.

⁷ The Action Plan sets out a range of measures for achieving this saving including the National Retrofit Programme, supports to business for energy efficient technologies, a targeted energy reduction of 33% in the public service and the development of electric vehicles.

2.2.2 *Telecommunications*

Ireland compares favourably on international telephone costs and high use mobile packages as well as low speed broadband. Over the past three years internet subscriptions have trebled and broadband speeds have doubled. However the economic importance of this area demands continued progress and further improvements in quality and reduction in cost will be needed.

It will be important to ensure a high standard of international connectivity and to enhance the IT capacity of the network. Overall, the policy framework provides that investment in broadband infrastructure is primarily a matter for the market. State intervention is aimed at improving our digital skills, enhancing our international connectivity and addressing market failures where they exist.

Action Points

- The regulatory regime will facilitate a collaborative approach to private investment.
- The Next Generation Broadband Taskforce will work with industry to enhance the business case for investment in NGN (Next Generation Network) delivery.
- Appropriate State investment will be undertaken in cases of market failure.
- The use of state infrastructure for the roll out of NGN networks will be maximised.

2.2.3 *Professional Services*

In general, the cost of services to businesses has fallen, but this is not uniform across all professions. Although accounting costs have fallen, the cost of legal services remains high.

Action Points

- Competition in the professions will be promoted and overseen by an independent figure, reporting regularly to Government.
- The Government will identify further ways to tackle increases in insurance costs, building on achievements of the Personal Injuries Assessment Board.
- All the restrictions on appropriately trained General Practitioners who wish to hold GMS contracts will be abolished.
- Provide for a more structured approach to mediation in the legal system and promote further the use of Alternative Dispute Resolution taking into account recommendations of the Law Reform Commission in its Final Report 2010 on the subject.
- A package of measures to reduce legal costs will be implemented, including
 - increased use of tendering by the State;
 - prioritising publication and enactment of the Legal Costs Bill; and
 - additional proposals for legislation to reduce legal costs, drawing on the recommendations of the Legal Costs Working Group and the Competition Authority.
 - Provide for increased use of arbitration and mediation.

2.2.4 *Office Space/Property*

The construction cost of prime industrial sites fell by 14% between 2008 and 2009. Notwithstanding this reduction, costs in Ireland are still among the highest benchmarked by the NCC. The same applies to industrial rental costs, though office rental costs are now relatively competitive with a reduction of 18% recorded in 2009. There is scope for further improvement in this area.

Action Points

- The proposals of the Working Group on Transparency in Commercial Rent Reviews will be implemented.
- The Office of Public Works will lead a coordinated effort to reduce office rents by up to 15% and review the efficiency of property arrangements across the public sector.
- Proposals will be brought to Government for legislation to overhaul and streamline the property revaluation process. The possibility of secondment of staff from local authorities is being explored.

2.2.5 *Efficiency in Public Administration*

The Government charges for delivering services such as local government utilities and business administration. In addition, companies incur indirect costs in complying with regulations (health and safety, financial etc). Companies also incur costs in searching for business support services and in accessing similar services from multiple State providers. The Government will take specific steps to reduce the cost base for the private sector. This is part of the Public Sector Transformation programme (including the Croke Park agreement mechanisms) outlined in Chapter 4. The efficiency recommendations of the Local Government Efficiency Review Group will also play a role in streamlining administration.

The Government will take the following steps to improve public administration for the benefit of business customers:

Action points

- The 15 day prompt payment rule will be extended beyond Government Departments to the wider public sector.
- Over the duration of the plan, increases in government administrative charges⁸ will be avoided, and the scope for reductions examined where possible.
- The targeted 25% reduction of the regulatory burden on business will be achieved by end-2011.
- Local Authorities will be required to improve their efficiency, including through implementing relevant recommendations of the Local Government Efficiency Group, to reduce where possible, the level of rates charged to businesses.

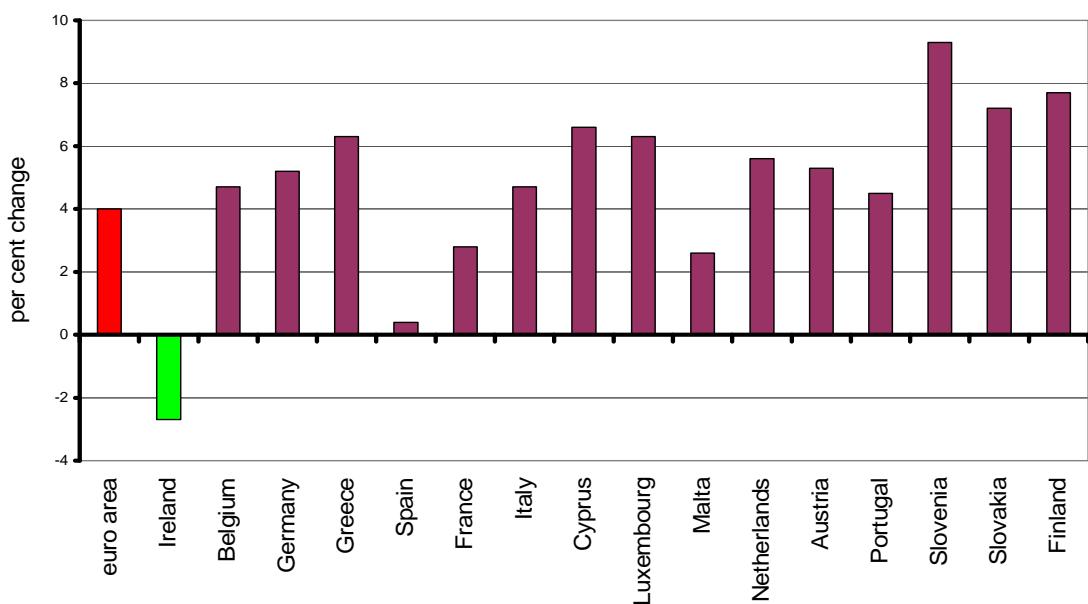
⁸ This excludes levies payable by entities regulated by economic regulators e.g. ComReg, Commission for Energy Regulation, Central Bank etc.

2.3 Removing Barriers to Employment Creation and Disincentives to Work

The central objective of this plan is to create the conditions for growing jobs and tackling unemployment. Although productivity and efficient use of resources will be important for economic recovery, unit labour costs must also be maintained at competitive levels. Labour costs are the key element in overall cost competitiveness. Labour costs also affect the cost of other inputs to the enterprise sector and play a critical role in influencing employment levels.

A process of adjustment is underway: in 2009 there was a 6.75% improvement in unit labour costs vis-à-vis the euro area as illustrated in Figure 2.2.

Figure 2.2 Change in unit labour costs, 2009



Source EU Commission Spring 2010 Forecast

The official unemployment rate for the second quarter of 2010 was 13.6%. The extent of the unemployment problem varies geographically with the mid western and south eastern regions registering higher unemployment rates at 16.3% and 18.1% respectively. Similarly, there are differences across sectors with the industry, construction and retail sectors recording the largest percentage decreases in employment numbers. Given the scale of the unemployment problem, any legislative and policy obstacles to job creation must be removed. The State must also act to enhance the incentives to the unemployed to take up job opportunities. This combination of State interventions in the labour market must be carried out in an integrated manner.

2.3.1 Dismantling Barriers to Employment and Facilitating Employment Growth

Introduced in 2000 at a rate of €5.59, the National Minimum Wage (NMW) is currently set at €8.65. It has been increased six times since its introduction and is now 55% higher than its original level. By end 2010 the consumer price index is forecast to have increased by approximately 28% since 2001.

Our NMW is the second highest in absolute terms compared to other EU countries and is sixth when expressed in purchasing power terms. As a percentage of the average gross monthly earnings, Ireland has the sixth highest NMW.

The majority of minimum wage workers are employed in textiles, retailing, hotels, restaurants and bars, and personal services. Employment in occupations covered by the NMW is typically dependant on domestic demand and is likely to be sensitive to changes in the wage rate. Given the desirability of growing employment in those sectors where significant jobs losses have occurred, and the importance of encouraging recruitment of young people in particular, the level of the minimum wage has significance beyond the numbers currently employed at that rate.

Where a NMW is imposed at a level higher than the equilibrium wage rate, unemployment will result. Some workers will be willing to work for a wage lower than NMW but employers are restricted from providing these job opportunities. Other negative effects include:

- Acting as a barrier for younger⁹ and less skilled workers to enter the labour force and take up jobs;
- Preventing SME's from adjusting wage costs downward in order to maintain viability and improve competitiveness; and
- Reducing the capacity of the services sector to generate additional activity and employment through lower prices for consumers.

The NMW was introduced during a period of sustained economic growth and rapid wage increases. Our circumstances have changed dramatically in the last three years. Price levels have reduced and earnings have adjusted downwards to help to preserve jobs. A reduction in the minimum wage level – as proposed by the OECD¹⁰ - can also be expected to remove a barrier to job creation. Therefore the Government have decided to introduce legislation to reduce the rate of the minimum wage by €1 per hour, or 12% to €7.65¹¹.

Action point

- The minimum wage will be reduced by €1 to €7.65.

The new rate will remain in the top tier of EU minimum wage rates.

Other regulated wage levels exist in certain sectors where employers and workers reach specific agreements about pay and conditions of employment, either through Registered Employment Agreements (REA's) or Employment Regulation Orders (ERO's), following consideration by Joint

⁹ According to CSO QNHS Quarter 2 2010, youth unemployment is 25.8% for the age group 20 to 24.

¹⁰ OECD (2009) *Economic Survey – Ireland*.

¹¹ Proportionate reductions of 12% will also take place for minimum wage rates related to employees under 18 years of age and employees aged 18 or over in their first and second years of employment.

Labour Committees. The terms in each case are protected by legislation. These agreements apply mainly to the agricultural, catering, construction and electrical contracting sectors. Pay rates are typically above the NMW and in some cases incorporate significantly higher wage levels.

Both types of agreements constitute another form of labour market rigidity by preventing wage levels from adjusting. This in turn affects the sustainability of existing jobs and may also prevent the creation of new jobs, particularly for younger people disproportionately affected by the employment crises who form part of the labour force for these sectors.

Consistent with a proposed reduction in the minimum wage, it is important that any barriers to employment are removed in these regulated sectors given their significance for the traded sector of the economy. There is also a need to ensure these agreements are fit-for-purpose in the current economic climate. There is a strong case for removing anomalies and obsolete provisions, so as to have a more streamlined, transparent and flexible model of wage setting.

Three particular aspects of these arrangements have been identified as potentially problematic from a competitiveness and job creation perspective. These are:

- Specific cost-increasing conditions such as pay rates for Sunday working;
- Geographical divisions which can sometimes appear arbitrary; and
- Inflexibility in measures for adjusting agreements in line with broader labour market developments.

These issues must be addressed in order to assist competitiveness and employment growth in these important sectors.

Action Point

- A review of the framework REA and ERO arrangements will be undertaken by the Minister for Enterprise Trade and Innovation, to be finalised within three months.

2.3.2 Removing Disincentives to Work

Social policy must continue to protect the most vulnerable in society and provide supports to those in unemployment. At the same time, our social protection system must not contain poverty traps and must not discourage those who are unemployed from returning to work.

The jobseeker rate of social welfare payment almost doubled between 2001 and 2009 before being reduced in Budget 2010 to €196 per week. This rate of increase has had implications for replacement rates¹² in the labour market which will also be impacted by the decision to reduce the minimum wage.

¹² The replacement rates for given income levels measures the proportion of out of work benefits received when unemployed against take home pay if in work.

The persistence of high replacement rates can act as a major disincentive to work. Replacement rates of the order of 70% can be considered to be a barrier to employment.

Analysis of estimated replacement rates for different earning levels and family types undertaken by the Department of Finance in late 2009 revealed the following findings:

- In general, single people face high replacement rates at the earnings level of the NMW, but the issue does not arise for higher earning single people;
- Couples where both are not working face high replacement rates at income levels up to the average industrial wage;
- Couples with children where both are not working have higher replacement rates again; and
- One-parent families have low replacement rates except in cases where out-of-work income is supplemented by earnings from the community employment scheme.

Rate reductions have been introduced for new jobseeker claimants under age 25 and without child dependants. The Qualified Adult rates applicable were also reduced. These rate reductions have had a significant downward impact on replacement rates for such claimants.

In some cases, the effects of the proposed changes to the minimum wage will be to increase replacement rates. OECD analysis has pointed to a danger that the high rate of unemployment in Ireland could be sustained owing to weaknesses in activation policy and high replacement rates for those on below average wage levels¹³. Therefore, there is a need to strengthen activation measures and to ensure that replacement rates are not acting as a barrier for any cohorts in unemployment. Achieving the right balance between the level of the NMW, labour legislation, social welfare rates, taxation and levels of activation is crucial to avoiding work disincentives.

High replacement rates need not necessarily give rise to high unemployment provided there is an effective activation strategy in place. Given the current dynamics in the labour market however, high replacement rates are viewed as a disincentive to work.

Action Points

- Reform of the welfare system will reduce unemployment traps by incentivising employment and discouraging a long term attachment to the social welfare system.
- This will assist in removing disincentives to work and will be complemented by strengthened activation measures.

2.4 Re-orienting Activation Measures

International evidence indicates that appropriate activation measures can increase the incentive to work, reduce the number of long term unemployed and increase aggregate employment. In particular,

¹³ OECD (2009) *Economic Survey of Ireland*.

activation measures can help ensure that those at risk of long term unemployment¹⁴ are ready to avail of employment opportunities when economic recovery takes hold. It is critical that the unemployed are equipped with relevant skills and kept close to the labour market. There is a need for appropriate upskilling or reskilling so that the labour market can access the skills it requires.

Elements of the Government's Activation Policy

Increased levels of engagement with the unemployed

- The National Employment Action Plan¹⁵ has increased substantially the number of interviews provided for the unemployed.
- Group interviews for the unemployed will be held after 3 months.

Training/work experience places

- Significant numbers of additional places have been provided for education, training/work experience for the unemployed since 2008.
- The Work Placement Programme allows for up to 2,000 individuals to participate in work for periods of up to 9 months while in receipt of social welfare payments.
- Allocations from the Activation Fund (€20 million) and the European Globalisation Fund were used in 2010 to provide additional options to help people back to employment.

Increased incentives for employers to create jobs

- The Employers' PRSI scheme to encourage employers to recruit people who are unemployed was introduced in July 2010.

Increased incentives for the unemployed to progress

- The targeted reductions in social welfare rates introduced in recent budgets have incentivised those under 25 to participate in education, training or work.
- Legislation has been put in place so that receipt of benefit payments will be conditional on participation in the National Employment Action Plan.

The Government is improving the efficiency of activation structures by streamlining the Public Employment Services. The Community Employment Scheme and the FÁS employment services are being merged with the Department of Social Protection providing a single employment service for jobseekers. This will facilitate central monitoring and control of conditionality measures.

¹⁴ This includes former employees in declining sectors such as manufacturing and construction.

¹⁵ The Irish National Employment Action Plan was adopted by Government in response to the European Employment Guidelines. The Plan includes a commitment to a more systematic engagement of the Employment Services with the unemployed. Implementation of this commitment commenced in September, 1998.

The scale of the unemployment problem justifies the introduction of further measures to improve national activation policies as recommended by the OECD. The focus must be on the provision of structured pathways to employment for those on the Live Register.

Action Points

A strengthened framework of additional activation measures will include:

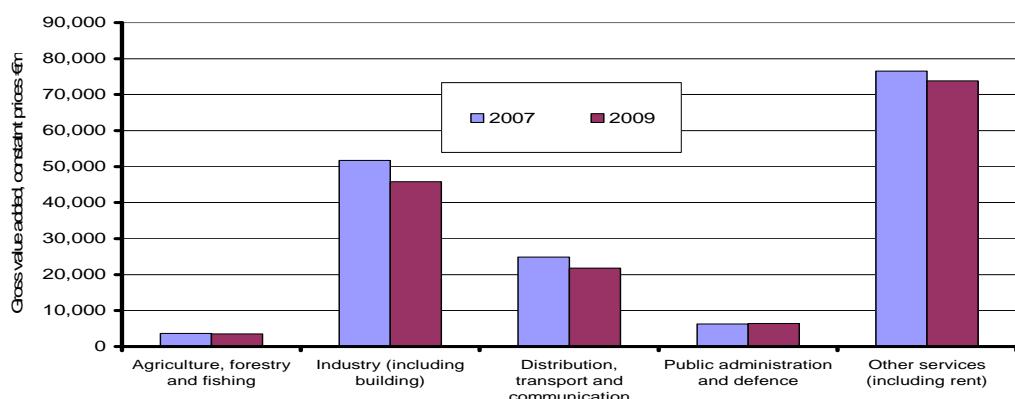
- A community work placement programme.
- A Skills Development and Internship Programme.
- Additional placements on the work placement scheme.
- The extension of the PRSI Employers Exemption Scheme to end-2011.

2.5 Enterprise Policy - Investment, Exports and Sectoral Performance

2.5.1 Sectoral Outlook

Figure 2.3 presents data on the sectoral contributions to gross value added (GVA) in the economy and how these have changed in recent years. GVA declined sharply in the Industry (including building) category. Value added also decreased in the distribution, transport and communication and other services sectors, reflecting the reduction in domestic demand and the impact of the financial crisis.

Figure 2.3 GVA by Sector, 2007 and 2009



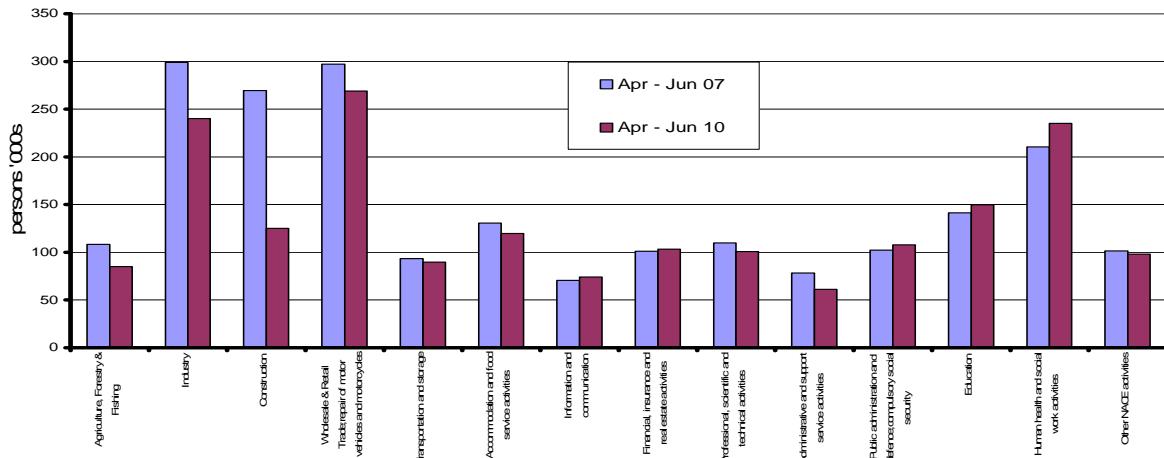
Source: CSO

The largest falls occurred in 2009 when GDP decreased by 7.6%. In that year,

- industry and building output decreased by 7.8%;
- distribution, transport and communications output decreased by 9.3%;
- other services output decreased by 2.3%; and
- public administration and defence output decreased by 0.5%.

Figure 2.4 presents the sectoral distribution of employment in the economy comparing data for Quarter 2 2010 and Quarter 2 2007.¹⁶ Not surprisingly, construction is the most affected sector. Encouragingly, employment increased in high value sectors such as information and communications technology and financial, insurance and real estate activities.

Figure 2.4 Employment by sector, 2007 and 2010



Source: CSO

2.5.2 Investment and Innovation

Attracting Foreign Direct Investment (FDI)

The attraction of FDI has driven growth in the Irish economy in the past and can do so again in the next phase of Ireland's economic development. Foreign investment in Ireland is substantial in nature: IDA supported companies alone sustain over 135,000 jobs. Manufacturing of pharmaceuticals and medical devices, financial services and the provision of ICT and professional services are the key sectors. As noted in Chapter 1, our performance in this area has remained robust throughout the recession. Further steps can be taken to copper-fasten Ireland's attractiveness as a location for internationally mobile investment.

The implementation of the Government's Trade, Tourism and Investment Strategy will encourage niche areas such as converging technologies to make Ireland a strategic base for multinational corporations (MNC's). Government Departments will seek to form partnerships with multinational companies based in Ireland to develop, trial and roll out innovations which improve services in Ireland and can also have worldwide application.

Supporting Indigenous Business

Indigenous businesses, including large firms, high potential start ups and SME's, are a major source of employment. They provide essential goods and services nationwide and are pivotal to the success of

¹⁶ The sectoral classifications by which GVA and employment data are published do not match exactly.

larger enterprises. They are also successful exporters in their own right. The range of competitiveness measures and labour market reforms outlined earlier will assist these firms through these difficult times and lead ultimately to growth. A number of further steps will be taken to encourage small business development.

Action Points

- The Business Expansion Scheme will be overhauled and improved. Full details are contained in Chapter 6.
- Enterprise agencies will work with SMEs to improve performance, productivity and competitiveness, assist them in developing exports in new and existing markets, help them to access public procurement opportunities and help firms develop a greater online presence.
- Core R&D supports and the innovation voucher system will continue to help small firms acquire cost-effective R&D and to move up the value-chain.
- The Government will investigate the potential for providing access to vacant or under-utilised public property for entrepreneurs or business start-ups to use as incubation centres.
- The Government is undertaking an overhaul of bankruptcy legislation.
- The 15 day prompt payment rule will be extended beyond Government Departments to the wider public sector.

Making Ireland a Global Innovation Hub

The Innovation Taskforce reported in March 2010 with recommendations to make Ireland a Global Innovation Hub. The aim is to make Ireland:

- The best place in Europe to turn research and knowledge into products and services;
- The best place in Europe to start and grow an innovative company;
- The best place to relocate or expand and scale an SME; and
- The best place in Europe for research-intensive multinationals to collaborate with each other and with clusters of small companies.

In support of these goals, a number of important recommendations made by the innovation taskforce will be delivered.

Action Points

- Innovation Fund Ireland will attract international venture capital fund managers to Ireland, making their expertise, experience and network available to our enterprises.
- IDA will introduce the European Accelerator Programme to attract fast growing firms to locate their European HQ in Ireland.

- Enterprise Ireland (EI) will introduce a new approach to providing seed capital and other supports to innovative start-ups.
- EI will assist Irish firms to maximise export potential through programmes for CEOs, mentoring and trade missions and will launch a campaign to attract overseas entrepreneurs to locate in Ireland.
- The 'Silvertech' initiative will be introduced and the HSE will work closely with multinational companies in Ireland on the introduction of new technology for healthcare.

Embedding Science, Technology and Innovation

Ireland has built a strong science base, and has joined Finland, Germany and the US in the world's top twenty countries for scientific output. Two thirds of Ireland's R&D is in the private sector, creating new product and service innovations that will drive exports, growth, and jobs. In 2009, nearly half of IDA investments were in research, development and innovation - activities that are central to productivity and new business development in Ireland's multinational sector. Indigenous enterprises continue to embrace R&D. Even during the downturn, these enterprises have proven they can grow exports and create employment. Productive, high calibre research, undertaken by highly skilled research teams working closely with industry partners will continue to be a core investment priority for Government. This new competitive advantage will be one of the key drivers of Ireland's economic recovery. But there must be a greater focus on the commercialisation of research outputs. Only world-class research projects should be supported and researchers need not necessarily be engaged across all disciplines. In sectors where we cannot be world leaders, the focus should move to technology transfer and utilisation of research elsewhere.

Action Points

- Research investments will be concentrated in areas where Ireland will secure the greatest economic and social returns.
- The number of industry led research competence centres will be doubled to ensure that industry drives the research agendas.
- IDA and EI will foster research, development and innovation in companies to boost productivity, exports, growth and jobs.
- Ireland has built a reputation as a country where enterprise can partner effectively with third level institutions. This will be developed at all levels ranging from SFI funded fundamental research centres (CSET's and SRCs) to EI Innovation Partnerships and Innovation Voucher programmes.

Fostering the Green Economy

The fast-growing Green Economy is an area where Ireland has huge potential for growth. The High Level Report on the Green Economy highlighted the growth and jobs potential in the following areas:

- Energy export potential

- Green IFSC
- Water management
- Ireland as a test-bed location and research hub
- Potential for convergence of ICT and energy management systems

The National Retrofit Programme has also provided work for the construction sector. There is scope to exploit the potential of over 250 companies (including high potential start ups) in the CleanTech sector. The Finance Act 2010 also contained measures to support the development of the Green Economy. Further steps in this regard include:

- Investing €4.5 billion in our transmission distribution and international interconnection grids to develop our renewable resources.
- Developing Ireland as a centre of new Smart Grid technology using our advantage in a flexible grid infrastructure and as a location for energy ICT companies.
- Identification of skills needs to capitalise on the green economy and design of appropriate courses and training to deliver these skills.
- The publication by Government of the Green Public Procurement Plan.
- Exploiting the potential of green financial services.

2.5.3 Strategy for Manufacturing and Agri-food Export Growth

Manufacturing growth was a key driver of Ireland's economic expansion in the 1990s and into the last decade. Although changes in the cost environment have posed challenges for manufacturing industries, the constituent sectors can re-position themselves by moving up the value chain, exploiting new market opportunities, including those in the BRIC countries, diversifying into market niches, and consolidating activities to achieve efficiencies.

In 2009, manufacturing exports amounted to some €84 billion¹⁷ and represented 56% of all exports by value. Recent data show an increase of 12.8% in merchandise exports (broadly equivalent to manufacturing) in Quarter 3 2010 compared to the same period in 2009. This can be attributed to growth in Ireland's main trading partners and improvements in our competitiveness. The agri-food sector performed particularly well.

The broad 'Life Sciences' sector encompasses chemicals, pharmaceutical and medical devices companies and is a key exporting sector. Total exports for the sector account for 57% of the value of all Irish goods exports¹⁸. Eight out of the world's top ten pharmaceutical companies have manufacturing operations in Ireland. Growth in this sector has driven Ireland's positive export performance during the recession. Ireland has a strong reputation in this area underpinned by core engineering skills and expertise in designing and constructing state-of-the-art manufacturing facilities. The industry has responded to the challenges of international competition and downward cost

¹⁷ CSO (2010) *External Trade July and August 2010*

¹⁸ CSO External Trade Data, Forfas calculations

pressures by enhancing productivity and seeking to cut costs. Broad conditions remain positive for this sector in terms of the available workforce supports from the enterprise agencies and the solid international reputation in terms of regulatory compliance. The measures relating to cost competitiveness set out in previous sections, particularly the reductions in energy costs, will assist this sector in over-coming medium-term challenges.

The **ICT** manufacturing sector in Ireland accounts for approximately 7% of manufacturing exports. The sector has experienced a decline in output over the last two years and some multinationals have moved their manufacturing activities to lower cost locations. At the same time, a number of these companies have increased their services operations here. The concentration of leading ICT companies remains high for a country of Ireland's size and there are good prospects for recovery. The success of the IDA in attracting R&D projects to existing manufacturing sites will help anchor manufacturers and shift activities in Ireland further up the value chain. The tax environment remains favourable for inward investment and an improvement in cost competitiveness will also support medium term growth.

Action Points

Government will

- Provide significant funding through IDA Ireland, EI and Science Foundation Ireland, along with other R&D supports relevant to the sector.
- Deliver the Health Information Bill which will speed up ethical review of health research trials and investigations.
- Invest in R&D industry/third level sector collaboration.

2.5.4 *Strategy for Services Export Growth*

The services sector has been one of the success stories of the Irish economy over the past decade. In 2000, this sector accounted for just 21% of total exports. By 2009, services exports were valued at €66.6 billion and represented 44% of total exports by value¹⁹. The ESRI forecasts that services will make up 70% of total exports by 2025²⁰. Although exports of indigenous services are growing, there is scope to accelerate growth.

Along with the sectors discussed below, opportunities for the internationalisation of traditional services areas will be exploited. For instance the Government will implement the International Education Strategy and Action Plan to improve Ireland's competitive position as a centre for international education.

This **financial services** sector covers international banking, funds management, shared services, investment management and insurance. Financial services exports accounted for 20% of total services

¹⁹ CSO (2010) *Services exports and imports 2008 and 2009*

²⁰ As cited in National Competitiveness Council (2009) *Driving Export Growth – Statement on Sectoral Competitiveness*.

exports in 2009²¹ with the IFSC playing an important role. Many leading international financial services firms have operations here. Although financial services exports decreased by 7.2% in value in 2008²², employment figures have remained steady in the sector with a small decline in the numbers employed in international banking offset by growth in the international insurance industry. Recent data show a strong export performance by the financial services sector. The Government has taken a number of steps to support the sector in recent years including measures in the Finance Act 2010 to improve the competitiveness of the international funds industry and to encourage Islamic finance products. Future options for the sector will be identified through a Strategy Review by the IFSC Clearing House Group, to be published early in 2011.

The **digital economy** is a key part of the Smart Economy. It involves the rollout of an extensive Next Generation Network and also the fostering of cloud computing services and its attendant new applications.

Ireland is host to many of the world leaders in software such as Yahoo, Microsoft and Oracle, some of whom have located R&D centres here. Although such multinational companies account for the majority of software exports from Ireland, indigenous companies have grown in significance. Irish companies now account for €1 billion of total software exports of approximately €23 billion²³. These firms have developed strengths in the e-learning, financial services and telecommunications applications.

The sector is an important source of high value jobs in the economy and while it is undergoing a period of consolidation (as companies seek to aggregate their activities in regional headquarters and to minimise their cost base) exports of Irish-based grew strongly in Quarter 3 of 2010.

Opportunities exist for indigenous software companies in traditional sectors (e-learning, financial services), tailored software solutions and hosted/managed services. The games software sector is also an emerging area of opportunity and there is scope to build on Ireland's growing reputation as a prime location for the industry, potentially through the introduction of specific supports. The underlying conditions for multinational companies remain positive with continual improvement in the R&D infrastructure.

Government has invested in an Exemplar Network that will act as a test bed for indigenous and international R&D into the next generation of data management.

The Government is determined to maintain Ireland as a manufacturing as well as a services economy, and our improving cost competitiveness, particularly in energy cost, will assist this.

²¹ CSO Service imports and exports bulletin. Forfas Calculations, CAGR between 2000 -2009

²² NCC (2009) *Getting Fit Again*

²³ Department of Enterprise, Trade and Innovation (2010) *Trading and Investing in a Smart Economy*.

Action Points

Government will:

- Provide direct supports for R&D and other business activities through the enterprise development agencies.
- Roll out 100 megabit connectivity to second level schools.
- Continue the roll-out of the National Broadband Scheme.
- Develop the use of ICT as an enabler of energy efficiency, which is a key area of growth.
- Working with relevant industry partners will help SME's to better exploit the opportunities of global online markets by helping them create their first website and upskilling their capacity in online sales.
- Continue the modernisation of financial regulation according to best international practice.
- Develop Ireland as a centre for Green Data Centres and establish an International Content Services Centre.
- Explore the potential of green financial services.
- Complete a strategy review by the IFSC Clearing House Group 2011.

2.5.5 Key Sectors for Growth

This section deals with key labour-intensive sectors that will provide increased job opportunities as the economy recovers. These sectors will particularly benefit from the combined impact of the reduction in the NMW, the review of REA's and ERO's and increased cost competitiveness.

Agri-Food Industry

Exports by this sector amounted to approximately €7 billion in 2009, representing half of all exports by indigenously-owned firms. Sub components of the sector include meats, dairy products, prepared foods and drinks. The sector is highly labour intensive and is a vital part of the rural economy. 2009 was a disappointing year for agriculture with a decline in outputs and income but the sector's performance has improved in 2010. During the first five months, the value of exports was more than 8% higher than a year earlier, at almost €3 billion. The rate of recovery has accelerated as the year has progressed. Exports grew by 14% in the third quarter. Export prospects for the major agri-food product categories for 2010 are generally positive, as better market prices and a more stable economic picture across Ireland's key markets underpin trade.

Food Harvest 2020 and Bord Bia's Pathways to Growth strategy set out a roadmap for the sector and provide the framework for boosting competitiveness and increasing employment. The Food Harvest committee concluded we can grow our primary output by one-third, and our value added and exports by around 40%. This ambition is partly driven by the expected growth in global food markets and partly by our own strategic advantages as a food and drinks producer.

Future policy must be focussed on areas where competitive advantage can be achieved. The sector must become more innovative by investing in research, providing what the consumer wants, applying lean manufacturing techniques and ensuring we have the scale at every level to maximise our cost competitiveness. There must also be a focus on environmental sustainability, while continuing to support and develop primary production. We must build on our green image and market the environmental sustainability of our food production systems.

The ending of milk quotas in 2015 provides a unique opportunity for a step change in the scale of our dairy sector, with a 50% increase in milk output envisaged by 2020. Growing demand for seafood (including aquaculture) can be leveraged by developing non traditional species, improving quality and developing value added products from foreign landings for high value EU and niche markets. Consumer preferences for environmental sustainability and high quality can be exploited to increase prepared food and drink exports. Increased product differentiation and the use of genetic advances to boost productivity can contribute to growth in the beef and other meats sectors.

Along with measures to grow specific sub sectors, the energy cost competitiveness measures and the actions to improve wage flexibility outlined earlier in this chapter will increase profitability and employment in this sector which is particularly exposed to adverse exchange rate movements. Capital investment programmes will, where permissible, be targeted at producers with the best potential to achieve growth and competitiveness and at young farmers with relevant qualifications and robust business plans. Further consolidation and rationalisation is needed to generate the economies of scale and efficiencies necessary to increase commercial strength relative to other international competitors.

An Agri Research Advisory Group will be established to bring a greater industry focus to the design of research programmes which will reflect priority areas identified in Harvest 2020. The agriculture and forestry sector can also play a significant role in the development of renewable energy, for example, biomass. The potential of other technologies such as anaerobic digestion is also being appraised.

Action Points

Government will:

- Implement the key recommendations of Food Harvest 2020.
- Reconfigure the milk quota scheme.
- Promote lean manufacturing in the agri-food sector.
- Provide direct capital supports for marketing and processing.
- Support the consolidation and restructuring needed to enhance competition in the sector.

Tourism and Travel

Tourism has been a key sector for the Irish economy attracting foreign revenue and acting as an important driver of regional development. It contributes approximately 6% of all services exports and

is relatively labour intensive, providing opportunities across a range of skills levels. Tourism generates direct income in sub-sectors such as accommodation and catering. It also has a positive impact on other sectors such as transport and retail. In recent years, visitor numbers have declined from 7.8 million in 2008 to 6.9 million in 2009, a fall of almost 12%.

But conditions in the industry are favourable: recent World Economic Forum benchmarking ranked Ireland among the best performing countries for hotel rooms per capita, attitudes toward tourists and sports stadium capacity. Convention Centre Dublin is a pivotal attraction for business tourism – a growing market segment which can yield a high economic return.

The tourism marketing budget of €44 million for 2010 will maintain Ireland's visibility in overseas markets and keeps the level and value of marketing investment constant in real terms. Additional measures to boost performance in this sector include the expansion of practical business supports for tourism enterprises, the extension of the employment subsidy scheme to hotels and the launch of a €4 million domestic tourism marketing scheme.

A return to growth in tourism numbers is dependent on a recovery in external markets. But measures to improve the quality and diversity of the tourism product and our competitiveness will position the sector to take advantage of that recovery. Capital funding for the tourism sector will be focussed on completing the upgrade of major tourist attractions, developing a small number of key iconic attractions, improving infrastructure for recreational cycling, walking and water based activities and heritage attractions. Investment will also be made in cultural projects, historic properties and national monuments. Competitiveness measures such as reducing the minimum wage, increasing wage flexibility (through a review of ERO's) and more competition in locally traded services will improve the cost base and viability.

Future opportunities include the development of cultural tourism, ecotourism, outdoor activities and business/conference tourism. There are also opportunities for growth in new markets such as the Asia Pacific countries, South Africa and the Gulf states. It is planned to increase visitor numbers to 8 million by 2015²⁴. Achieving this target will expand employment in the tourism sector.

Action Points

Government will:

- Liberalise visa restrictions for visitors from long haul source markets.
- Invest in enhancing the visitor experience through quality tourism product (including attractions and infrastructure).
- Leverage existing cultural resources (the online Census and genealogical records, Aviva Stadium, Convention Centre Dublin etc) to raise Ireland's profile while

²⁴ Department of Enterprise, Trade and Investment (2010) *Trading and Investing in a Smart Economy*

maintaining investment in overseas marketing.

- Improve and facilitate tourism travel around Ireland.
- Work with stakeholders to augment access routes.

Retail and Wholesale

The retail sector is a major source of employment. Job losses, income reductions and higher precautionary savings have led to a substantial decline in personal consumption over the last two years. The paying down of household debt, uncertainty regarding job stability and the prospect of potential reductions in incomes due to tax increases continues to dampen retail demand. But recent CSO figures indicate that retail sales are stabilising and competitiveness has improved in the sector over the last two years.

As competitiveness increases and exports grow, employment will stabilise and begin to recover. This, together with the stabilisation of the public finances, will lead to greater certainty about future economic prospects and will in turn boost consumer confidence and lower the savings ratio from its currently elevated level. Higher consumption will increase employment in the retail sector.

Action Points

To support the retail sector, the Government will:

- Remove barriers to recruitment through the reduction in the minimum wage.
- Further improve the cost base through the measures to reduce input costs such as energy and property as outlined earlier in this chapter.
- Support an increase in consumption levels through measures to support the tourism sector.
- Enhance the efficiency of the sector through a reduction in transport times for delivery of goods as a result of investment in a number of key strategic road projects and road maintenance.

Construction

There has been a significant decline in employment in the construction sector caused by the severe contraction in new home building.

Demand for office and commercial accommodation can be expected to remain subdued. Recent analysis by the Department of Environment, Heritage and Local Government suggests that the oversupply in the housing market may be more pronounced in rural areas and that the overhang may be less significant in our cities. Pending the resolution of the housing adjustment, there may be a greater prospect for housing demand in our major cities. Government will take measures to help ensure the effective management and resolution of unfinished housing developments.

It is neither likely nor desirable that employment levels in the construction sector return to pre crisis levels. Nevertheless, a certain level of capacity must be retained to ensure skills and expertise built up in recent years are not lost for future activity. Incomes and employment growth in general will facilitate a return to a more stable long term equilibrium level of construction activity above the current level.

Action Points

Government will:

- Protect employment in the sector through a review of REA's.
- Support job retention through energy efficiency activities e.g. the National Retrofit Programme.
- Consider providing commercial opportunities for utility companies through the introduction of water metering.
- Develop Ireland as an international construction services centre, from which companies can compete for major construction contracts overseas.

2.5.6 Summary of Sectoral Considerations

Overall, Ireland must build on its strengths in ICT, health/life sciences, international financial services, agri-food and other internationally traded services. We will position ourselves to take advantage of emerging opportunities in green and cleantech technologies, marine and maritime industries, creative industries and other services. Combined with competitiveness reforms, the growth in exports in the manufacturing and services sectors previously discussed will boost domestic demand by creating employment and higher incomes.

2.6 Conclusion: Anticipated Medium-term Outcomes

The Government's strategy for an enterprise-led return to economic growth seeks to bolster the private sector to promote all areas of economic activity.

Some of the measures detailed above will impact on living standards of individuals and their families in the short-term. But these measures are essential if we are to bring the cost structure of the economy to a sustainable level and ensure that we respond flexibly to improved trading conditions as the recovery gains pace. In this way, existing jobs will be protected and new employment opportunities created. Realising these objectives will generate wider benefits. The labour market reforms contained in this chapter will have the effect of reducing unemployment and benefitting those most severely affected by the downturn, thereby fulfilling our national and EU commitments to combat social exclusion.

The measures detailed in this chapter will:

- enhance competitiveness through lower costs, productivity growth and innovation;
- support the growth of a successful, sustainable enterprise base;

- spur faster output growth;
- help to ensure that growth translates into gains in employment;
- help to bring down unemployment; and
- match those seeking work with suitable job opportunities more speedily so that spells of unemployment are on average shorter.

The macroeconomic forecasts which underpin the plan envisage GDP growth averaging 2.7% between 2011 and 2014. This pace of growth is expected to lower unemployment from its current rate of 13.5% to about 9.8%. These forecasts are based on the assumption that all the measures set out above are implemented and make some prudent allowance for the positive effects expected to flow from them. It is possible that the effects of the measures will be greater than has been incorporated in the forecasts.

Chapter 3 General Expenditure Context

Key Messages

- Two thirds of the budgetary adjustment will fall on the expenditure side – €10 billion.
- Reductions in current spending will amount to €2.1 billion in 2011.
- Capital spending will be €1.8 billion lower.
- Reductions are required in each of the three major areas of voted expenditure – the public service pay and pensions bill, social welfare and programme expenditure over the Plan period.
- The adjustment must be viewed in the context of significant expenditure allocations over the period 2000 to 2008.
- The adjustments in 2011 and later years will be determined on the basis of a coherent set of guiding principles for expenditure consolidation.
- The Government will reform the existing budget process.

3.1 Introduction

Restoring stability to the public finances is the centrepiece of this Plan. The day-to-day costs of running the State cannot be financed through borrowing on an indefinite basis. Reaching the challenging target of reducing the deficit to below 3% of GDP by 2014 requires structural reform of public spending and taxation. This Chapter provides an overview of the overall adjustment on the spending side.

Given the fall in GNP and the impact on Government revenues, the State is no longer in a position to afford the level of public services and social welfare rates of recent years. Because social welfare, pay and programme spending each account for around one third of total expenditure, reductions in each of these areas are unavoidable. These reductions will bring expenditure back to its 2007 level.

The planned expenditure element of the total budgetary adjustment is set out in Table 3.1 below. Current expenditure will be approximately €7 billion lower by 2014 compared to the projections based on existing policies, and capital expenditure €3 billion lower.

Table 3.1 Budgetary Consolidation Path 2009-2014							
	<i>2009* €billion</i>	<i>2010* €billion</i>	<i>2011 €billion</i>	<i>2012 €billion</i>	<i>2013 €billion</i>	<i>2014 €billion</i>	<i>% change 2010-14</i>
Opening position:-							
<i>Gross Current Expenditure</i>	55.7	54.7	54.9	54.7	54.8	55.1	1%
<i>Gross Capital Expenditure</i>	7.3	6.4	6.5	6.5	6.5	6.5	2%
Current consolidation**							
- annual			2.1	1.3	1.5	1.5	
- Additional impacts from 2011				0.4	0.1	0.1	
- cumulative				3.8	5.4	7.0	
Capital consolidation							
- annual			1.8	0.4	0.4	0.4	
- cumulative				2.2	2.6	3.0	
Total consolidation**				3.9	1.7	1.9	
- annual				0.4	0.1	0.1	
- Additional impacts from 2011				6.0	8.0	10.0	
- cumulative							
Revised expenditure position^:-							
<i>Gross Current Expenditure</i>	55.7	54.7	52.8	50.9	49.4	48.0	-12%
<i>Gross Capital Expenditure</i>	7.3	6.4	4.7	4.3	3.9	3.5	-45%

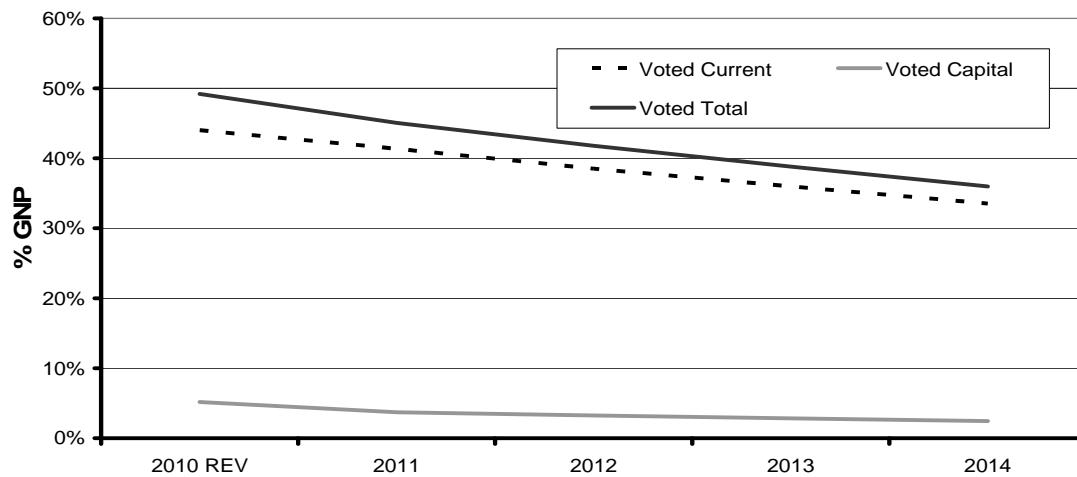
*As published in the Revised Estimates for Public Services 2010.

**Includes measures which impact on both gross and net voted expenditure.

^ The gross expenditure position does not reflect any adjustments made to appropriations-in-aid.

The Plan provides for a scaling back of current expenditure²⁵ by 11 percentage points of GNP, from 44% in 2010 to 33% by 2014. Total Government expenditure²⁶ (i.e. including capital) will fall from 49% to 36% of GNP over the period, as shown in Figure 3.1 below.

Figure 3.1 Expenditure Path, 2010 - 2014



Action point

- The total expenditure adjustment over the period of the Plan will amount to €10 billion, comprising of €7 billion current expenditure and €3 billion capital expenditure. As a result, total Government voted expenditure as a percentage of GNP will be reduced from 49% to 36% by 2014.

²⁵ Voted expenditure

²⁶ Voted expenditure

3.2 Why We Must Reduce Expenditure

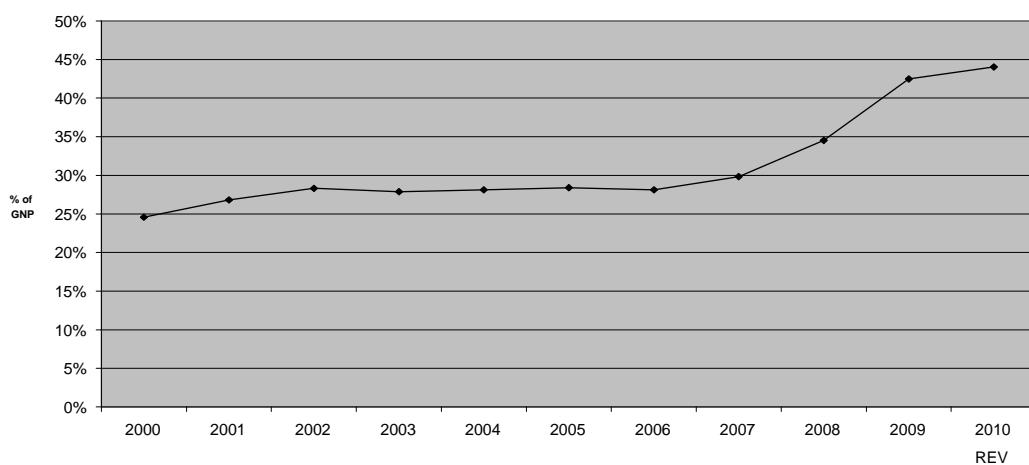
The planned reductions must be seen in the context of the rapid increase in public spending over the period from 2000 to 2008. This saw unprecedented improvements in the level and quality of public service provision in Ireland. In particular, major strides were made in improving social welfare levels, increasing expenditure on education and healthcare, and the stock of infrastructure in the economy was significantly enhanced. Table 3.2 below shows the rate of increases in the key areas of expenditure.

Table 3.2 Increases in Public Service Allocations 2000-2008

Public Expenditure area	2000 € bn	2008 € bn	% change 2000-2008
Social Welfare	6,829	17,741	+160%
Education	3,716	8,465	+128%
Health	5,362	15,356	+186%
Capital investment	3,930	9,011	+129%
Total expenditure	25,925	62,395	+141%
<i>Consumer Price Index</i>	-	-	+ 34.8%

These significant increases in public expenditure were broadly in line with the strong nominal growth rate of the Irish economy with expenditure as a proportion of GNP remaining at around 28% for most of that period. However, with the sharp fall off in growth since 2008, that ratio has risen markedly to around 44% of GNP in 2010, as shown in Figure 3.2 below. It is clearly not sustainable for public spending to remain at such a high level, and restoring overall expenditure back to an affordable level is now a key imperative of public policy.

Figure 3.2 Voted current expenditure, 2000 – 2010



The Government has already taken decisive action to restore stability to the public finances. Since 2008, significant re-prioritisation and reduction of expenditure has occurred. These adjustments have stabilised overall levels of spending, notwithstanding a large increase in the social welfare bill due to rising unemployment. The sustained programme of expenditure reduction undertaken by Government to date is outlined in the box below.

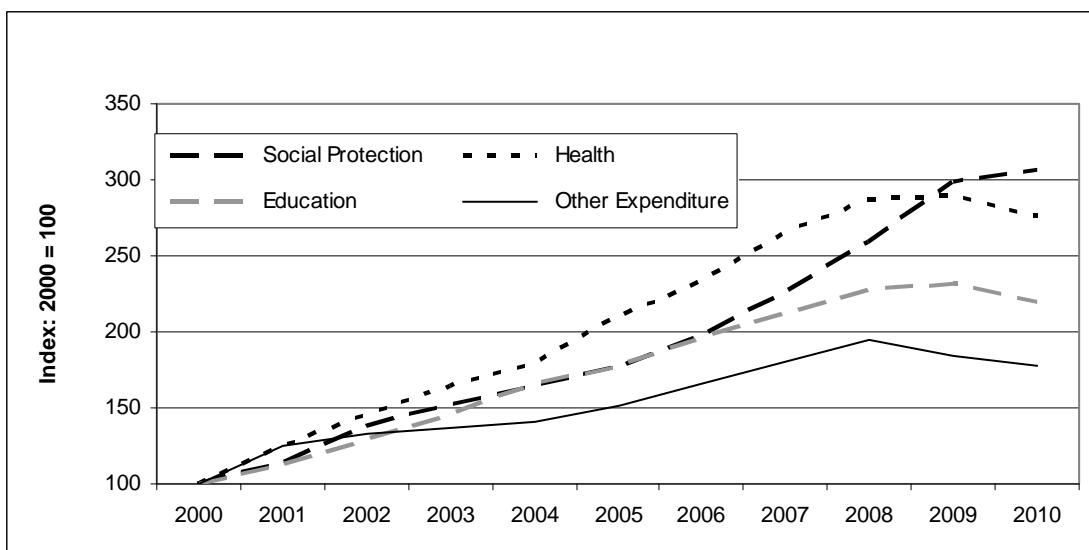
Summary of Expenditure Savings undertaken to date

- €1 billion in July 2008, arising from re-scheduling of the decentralisation programme, and a range of administrative savings on foot of the Efficiency Review that had been announced in Budget 2008 (December 2007);
- €3 billion in February 2009, arising from a range of efficiency and policy adjustments, including the introduction of a public service pension levy, and the postponement of pay increases that had been scheduled under the Towards 2016 partnership agreement;
- €1.8 billion in April 2009, on foot of a major round of programme savings and capital reductions announced in the *Supplementary Budget*; and
- €4 billion in December 2009, with a significant range of cuts in Public Service Pay, Social Welfare payments, as well as other programme areas and capital savings.

Taken together with other programme savings and containment measures in this period, including in Budget 2009, the overall expenditure consolidation exercise amounts to more than €10 billion, or 8% of this year's GNP.

The expansion in spending throughout the 2000s and the reductions since 2008 are illustrated in Figure 3.3 below. This Plan builds on recent savings initiatives to restore order to the public finances.

Figure 3.3 Expenditure Path by area, 2000-2010

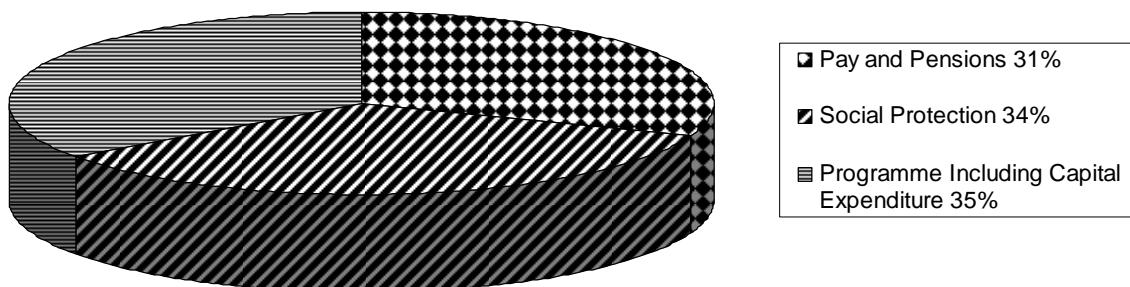


3.3 Composition of Expenditure

Achieving budgetary savings of the scale envisaged in the Plan requires a balanced and strategic approach. It requires a contribution from all of the principal components of expenditure and must be consistent with the Government's overall plan for restoring competitiveness and promoting growth and job-creation over the period ahead. In particular, it is essential that a streamlined and more efficient system of public administration makes a sizeable contribution to the budgetary adjustment and that front-line services are protected insofar as possible.

The broad composition of the three main elements of current expenditure in 2010 is set out in Figure 3.4 below.

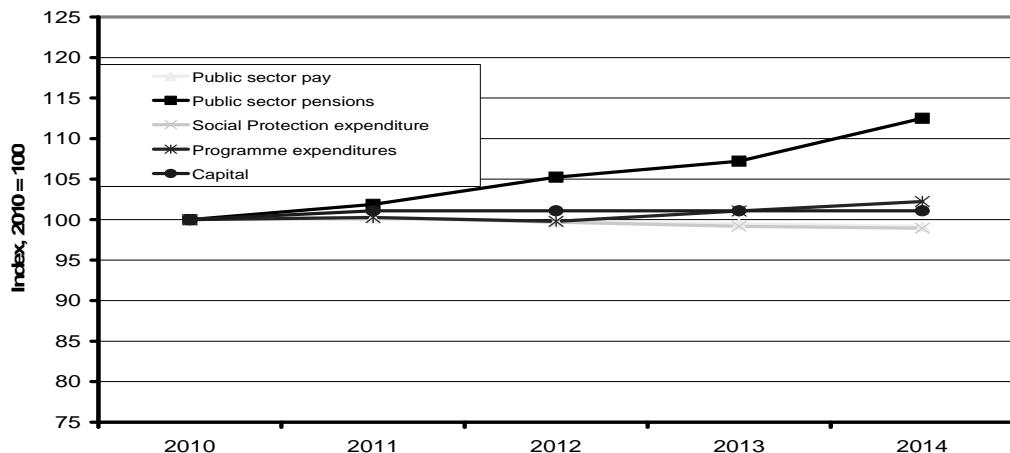
Figure 3.4 Broad Composition of Current Expenditure 2010



While efficiencies and the elimination of waste can play an important role, they cannot of themselves bridge the gap to any substantial extent. Material reductions across these three broad categories are therefore required.

It is useful to disaggregate these categories into public service pay, public service pensions, social welfare expenditure, programme expenditure and capital. On the basis of existing policies, expenditure across these areas would evolve over the period to 2014 as set out in Figure 3.5 below. This illustrates that public service pay - while a significant proportion of the total - is on a stable course, in contrast to public service pensions where costs are set to rise. The most pronounced increase is on social welfare payments; this is driven by both social welfare pensions spending due to demographic factors, and working-age social expenditures across the wide range of schemes and supports in this area (after taking account of the projected reduction in the Live Register).

Figure 3.5 Existing Path of Expenditure, 2010-14



3.4 Strategy and Principles for Expenditure Reductions 2011-2014

The expenditure reduction measures taken by Government over the next four years will have an ongoing effect on the economic and social fabric of the country. For this reason, it is important that decisions about these measures are grounded in a coherent vision of our medium term future.

It is widely accepted that continued targeted investment in education and innovation will enhance our future economic growth prospects. Our own experience from the 1980s and international evidence tell us that activation and other labour market measures play an important role in preparing those who have lost their jobs for a return to work as economic growth gathers pace.

It is also clear that healthcare and welfare systems that have taken years to evolve are important to maintain as far as possible. To guide expenditure choices over the next four years, the Government has agreed a set of principles which will inform a consistent approach to realising the savings necessary to achieve the target of a deficit of 3% of GDP by 2014.

These principles are:

- Future capital investment must be carefully targeted and more employment-focused;
- The costs of delivering public services must be brought down;
- The vulnerable must be protected as far as possible;
- Support levels must be restructured to preserve incentives;
- Essential Healthcare and Education services must be protected;
- All other programme expenditure, grants and subsidies must be scaled back to affordable levels; and
- Ministers and Public Service Managers must prioritise expenditure within cash ceilings.

These principles have shaped the expenditure measures for 2011 and the subsequent years of the Plan which are set out in Chapters 4 and 5.

The Principles for Expenditure Reductions Explained

Future capital investment must be targeted and employment-focused:

Overall capital investment in Ireland has been maintained at twice the EU average for a decade. The “infrastructure deficit” that constrained economic capacity in the past has been largely addressed. As many objectives have been met this area should provide major savings. The smaller allocation must be targeted on those areas that will help to underpin recovery, with job-intensive investment in building up our economic capacity.

The costs of delivering public services must be brought down:

The salary cost of doctors, nurses, teachers, Gardaí and other public servants account for about one third of day-to-day spending. A balanced approach to expenditure reductions still requires that the overall payroll bill be tackled. Public servants have had two pay reductions in 2009 and 2010 and it is appropriate to recognise their contribution. There is scope for further savings in payroll costs through number reductions. The Croke Park Agreement provides a basis for greater efficiencies and flexibility, without having recourse to further pay reductions. The commitments entered into by the Government under the Croke Park Agreement are dependent on savings being delivered.

The vulnerable in society must be protected as far as possible:

Social welfare accounts for one third of day-to-day spending. The Government will ensure that in achieving savings in this area, scarce resources are directed at those most in need.

Support levels must be restructured to preserve incentives:

The driving force for this re-balancing is the need to preserve incentives for people to take up work.

Essential Healthcare and Education services must be protected:

The health and education sectors account for €24 billion, or about 44%, of overall current spending in 2010. The Government recognises the importance of essential frontline healthcare and education services and will minimise the impact of reductions as far as possible. The focus must be on eliminating inefficiencies, cutting administrative overheads and examining all areas of expenditure to achieve value for money and to lessen the impact on service provision.

All other programme expenditure must be scaled back to affordable levels.

Significant savings must be found in this broad area of expenditure, including closing off schemes and programmes and reducing grants and subsidies. The traditional model of completely free provision for public services is not sustainable. A reasonable co-payment on the part of the citizen will (a) offset, to some extent, the Exchequer costs involved, and (b) lessen the waste arising from unnecessary oversupply, which is always a risk when goods or services are provided free.

Ministers & Public Service Managers must prioritise expenditure within cash ceilings:

Through setting cash ceilings for each expenditure area, the task of identifying the necessary savings for each year will be delegated to each Minister and Departmental head as part of the reformed Multi-Annual Expenditure Framework (see Annex 7). Overall expenditure levels will be fixed and prioritisation of expenditure and identification of savings will be embedded into the process of expenditure management.

3.5 Budget Reform

The budget system will be comprehensively reformed and updated to bring greater sustainability to the management of public finances; to achieve maximum value for money in public expenditure; and guard against the emergence of structural budgetary imbalances.

This process will take into account the recent recommendations of the Joint Oireachtas Committee on Finance and the Public Service in its recent Report on Macroeconomic Policy and Effective Fiscal and Economic Governance.

A reformed *Budget Formation Process* taking account of agreed EU-wide coordination and surveillance mechanism will be put in place. A budgetary timetable along the following lines is now being considered:

- *December*: annual Budget presented to Dáil Éireann, with detailed Estimates for the coming year (*year t+1*).
- Draft Stability Programme Update (SPU) projections prepared, together with proposed multi-year Ministerial Current Expenditure Envelopes, for the later years *t+2* to *t+4*.
- *January – April*: refinement of the draft SPU projections and multi-year budgetary policy objectives, taking account of the updated global and domestic economic outlook, and in the light of commentary from the Budget Advisory Council (see below) and the relevant Dáil Committee. In addition, the EU policy co-ordination processes culminate with the 'Annual Economic Summit' (European Council) and its Conclusions.
- *April*: The final Stability Programme Update for the years *t+2* and beyond is prepared in light of the perspectives received from the above policy inputs.
- *July*: EU-wide budgetary surveillance, on the basis of SPU documents, would be completed.
- *September - December*: Preparation of the December Budget and detailed Estimates for the following year, *t+2*, is ongoing, in line with the overall parameters set out in April's SPU document.

Reformed arrangements will also include:

- the extension of *Performance Budgeting* to identify more readily the results and impacts that are expected to be delivered with public funds - details in this regard are provided in Annex 6;
- new *VFM rules* to spotlight performance, and to assess whether spending programmes and investment projects are delivering real benefits;
- a *Medium-Term Expenditure Framework* with multi-annual ceilings on expenditure in each area, to ensure that public expenditure is managed within fixed, sustainable limits and to guide the planning and delivery of structural and policy reforms - further details in this regard are set out in Annex 7;
- a *Budget Advisory Council* to provide an independent commentary on the Government's budgetary planning, by means of assessing the appropriateness of the budgetary stance and aggregate budgetary targets being adopted; and
- a *Fiscal Responsibility Law* to put key reform measures on a statutory basis and to ensure that the principle of keeping the public finances on a sustainable footing is binding in law.

Further operational aspects of these reform measures will be set out in the forthcoming 2011 Budget.

Action Point

- The Government will reform and update the existing budgetary architecture, with details to be announced in the 2011 Budget.

Chapter 4 Current Expenditure Measures

Key Messages
<ul style="list-style-type: none">▪ Savings of €7 billion will be made on current expenditure by 2014.▪ 40% of the savings will be frontloaded in 2011 and will amount to over €2.1 billion in 2011 and over €2.7 billion in a full year.▪ Adjustments are required across all major categories of spending, namely:<ul style="list-style-type: none">- Public service pay bill (- €1.2 billion).- Social Protection expenditure (- €2.8 billion).- Other Programme expenditure (- €3 billion).▪ Further reduction of public service staff numbers for each sector to bring the overall reduction to over 24,750 or 8% on end-2008 levels.▪ More effective use of staffing resources with redeployment of staff within and across sectors of the public service to meet priority needs.▪ Reform work practices to provide more efficient public services with scarcer resources.▪ Introduce a reformed pension scheme for new entrants to the public service and reduce their pay by 10%.▪ Introduce a pension deduction for public service pensioners to yield €100 million in savings.▪ Increase the student contribution to the costs of third level education;▪ Introduce water metering by 2014.

4.1 Introduction

The expenditure choices set out in this Chapter are designed not only to return public spending to a sustainable level but to hasten economic recovery. For this reason, investment in education, innovation and enterprise has been maintained. The targets set for a reduction in public service staff levels will require a more efficient and effective public service that, together with the full implementation of the Croke Park Agreement, will enhance our competitiveness and deliver better services to citizens.

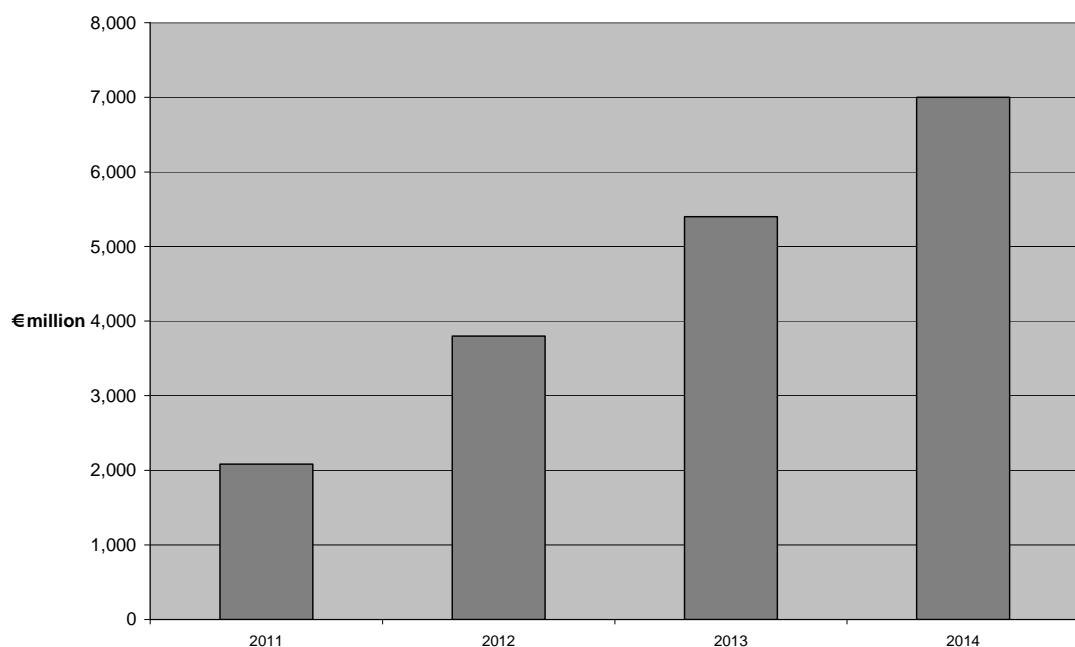
The measures contained in the Plan will reduce current expenditure to just over €48 billion by 2014, some €7 billion less than had been projected. Table 4.1 sets out the trajectory of gross current expenditure necessary to achieve the 2014 target which amounts to a reduction of 13% of 2010 spending. Expenditure savings of over €2 billion will be made in 2011 with somewhat lower annual savings targets set for each of the years 2012, 2013 and 2014.

Table 4.1 Composition of 2009/2010 Allocations and 2011-2014 Savings

	<i>Allocations</i>		<i>Adjustments</i> ^{27 28}				<i>% of 2010 Base</i>
	<i>2009 €bn</i>	<i>2010 €bn</i>	<i>2011 €bn</i>	<i>2012 €bn</i>	<i>2013 €bn</i>	<i>2014 €bn</i>	
Public service pay	17.4	16.0	0.3	0.7	0.9	1.2	-8
Public service pensions	2.6	2.8	-0.1	0	0	0	0
Social Protection expenditure	20.4	20.9	0.9	1.5	2.3	2.8	-13
Other expenditures	15.3	15.0	1.0	1.6	2.2	3.0	-20
Of which: Administration	1.2	1.2	0.1	0.1	0.1	0.1	-8
Subsidies, Grants and other schemes, Procurement	14.1	13.8	1.0	1.6	2.2	3.0	-22
Current Total	55.7	54.7	2.1	3.8	5.4	7.0	-13

All areas of expenditure will be reduced, on the basis of the principles set out in Chapter 3. Those areas where expenditure is highest will yield the greater part of the savings. The Government is determined to ensure that administrative streamlining and efficiencies, consistent with the Government's agenda of *Transforming Public Services* and with the commitments entered into under the Croke Park Agreement, will play their full role in delivering the required level of savings. This is essential if public services are to be reformed and delivered at a cost that can be sustained in the future.

Figure 4.1 outlines the scale of the expenditure savings to 2014.

Figure 4.1 Scale and composition of cumulative savings, 2011 to 2014

²⁷ The public service pay adjustment includes the associated fall in the pension-related deduction from reduced Public Service pay.

²⁸ The Public Service Pension adjustment includes the €100 million annual savings arising from the measures outlined in section 4.7. These savings are offset by the increased pension costs associated with the planned structural reduction in Public Service numbers, particularly in relation to lump sum payments in the earlier years of the plan.

4.2 Public Service Pay Costs

The Public Service Pay Bill has been reduced by over €1.4 billion in gross terms in 2010 over the 2009 outturn and now stands at just over €16 billion as a result of the reductions in public service pay rates and reduced staffing levels. Public service staff numbers have already been reduced by about 12,000 since peak levels at end-2008. This exceeds the targets adopted by Government in late 2009. In fact, the existing end-2012 target of 307,400 (whole-time equivalents) has effectively been achieved by end September 2010 (307,500) and will be comprehensively exceeded by end 2010 when the effects of the H.S.E. scheme are taken into account.

On the basis of existing policies and projections, public service pay costs will continue to fall. Sector-by-sector analysis indicates that, by continuing to build upon the control measures currently in force, we can now achieve a target level of 294,700 staff numbers by end-2014. This will return the public service to the numbers last seen in early 2006 and the public service pay bill to the level last seen in 2005. Table 4.2 sets out the planned position.

Table 4.2 Expenditure on Public Service Pay Bill²⁹

	2009 €bn	2010 €bn	2011 €bn	2012 €bn	2013 €bn	2014 €bn	% change 2010-14
Opening Pay allocation	17.4	16.0	16.1	16.0	16.0	15.9	-1%
Consolidation measures, 2011-14 ³⁰			0.4	0.7	1.0	1.2	-
Pay Expenditure Ceiling	17.4	16.0	15.7	15.3	15.0	14.7	-8%

The pay saving resulting from this reduction in numbers, coupled with a range of reforms and efficiencies will amount to €1.2 billion savings by 2014. Table 4.3 below set out details by Government sector. This gross pay saving will be offset by some increased pension costs in 2011 and 2012, as discussed in the section 4.7 below. There will also be additional savings in the local authority sector, not directly impacting upon the Exchequer.

Additional pay savings will be achieved through an immediate 10% reduction in the pay of all new entrants to the public service leading to a further sustainable reduction in public service pay costs over the medium term. In addition, all new entrants will start on the minimum point of the scale.

More generally, the Government has already taken action to reduce the pay of politicians and senior public servants. In 2009 the Minister for Finance ordered a fresh review of top level public service pay, to take account of the changed budgetary and economic circumstances, the changed private sector pay environment and to compare pay against that of other countries of comparable scale,

²⁹ This table presents the gross pay allocations and, as such, does not take account of the receipts of the pension-related deduction on Public Service remuneration, which is estimated to yield up to €1 billion in 2010.

³⁰ Does not include the associated fall in the pension-related deduction from reduced Public Service pay.

particularly in the Eurozone. This led to the Government reducing the pay of Ministers, TDs, Senators and other office holders, as well as senior civil servants and their equivalents across the wider public service.

The Government has also placed an appropriate salary limit on the CEOs of the largest financial institutions and ordered a cessation of the payment of bonuses. Salaries of other senior executives are being adjusted to bring them into line with the salary caps imposed on the CEOs.

In addition the Government has decided to carry out a review of the pay of the Chief Executives of commercial State bodies.

Table 4.3 Public Service Numbers at end year and associated Pay savings*							
	2000	2008	2010	2011	2012	2013	2014
Opening numbers ceilings	247,250	319,450	307,900	308,000	307,400	308,500	309,350
Numbers ceilings				301,000	298,800	296,500	294,700
<i>of which:</i>							
Civil Service	34,050	39,300	37,350	36,200	35,800	35,250	34,600
Health Sector	81,500	111,050	106,850	105,300	103,800	102,300	100,800
Education	67,850	94,650	93,700	93,300	94,100	95,050	95,750
Justice	12,250	15,700	14,800	13,750	13,600	13,400	13,250
<i>of which Gardaí:</i>		14,400	14,500	13,500	13,350	13,150	13,000
Defence	12,100	11,250	10,800	10,500	10,400	10,300	10,300
Local Authorities	29,100	35,000	32,200	30,750	30,400	30,000	30,000
NCSAs**	10,400	12,500	12,200	11,200	10,700	10,200	10,000
Annual Ceilings Reduction				7,000	8,600	12,000	14,650
Cumulative Numbers Reduction since 2008				18,450	20,650	22,950	24,750

* Numbers rounded to the nearest 50 whole-time equivalents.

** Non-Commercial State Agencies.

Over the last year, enhanced numbers monitoring systems and multi-annual frameworks have been put in place. These arrangements will be strengthened to ensure that effect is given to Government decisions on public service numbers.

The staff reductions required to achieve the end 2014 ceiling of 294,700 equate to an average annual reduction of approximately 3,300 in the number of serving public servants over 2011 to 2014. Delivering this reduction will require continued implementation of the moratorium on recruitment with

exceptions being limited to all but a limited number of essential posts and the utilisation of redeployment as the primary mechanism to fill posts which have been approved.³¹

The annual aggregate and sector ceilings outlined in Table 4.3 set out the minimum acceptable reduction in staff numbers and should staff exits exceed projected levels, the savings target by 2014 will be frontloaded. There can be no question of recruitment of replacement staff in any sector, except in the circumstances outlined above, until the reductions required to reach the end 2014 ceilings have been exceeded. On this basis, the overall numbers reduction of 24,750, relative to end-2008, represents a prudent basis for the delivery of numbers-based payroll savings. The Government anticipates that accelerated numbers reductions may make a further contribution to the overall payroll adjustment of €1.2 billion by 2014.

The reductions sought will bring Garda numbers back to 13,000, the level reached in 2006/2007. Civil service numbers will go back to 34,600 or 2001 levels, and HSE numbers will return to 100,800, the 2005 level. Education numbers will increase over the period reflecting demographic pressures and in line with Government commitments.

More generally, the savings arising from numbers reductions will need to be supplemented with significant savings from efficiencies and greater flexibility realised through a whole range of reform measures in accordance with the Croke Park Agreement. This will involve reductions in the costs of overtime, allowances, staff substitution and temporary replacement, and special payments across the public service. The National Recovery Plan has been prepared on the basis that the Croke Park Agreement will make possible the delivery of tangible savings. The commitments entered into by the Government under the Croke Park Agreement are dependent on savings being delivered.

4.3 Reforming Institutions and Service Delivery

This proposed reduction in numbers will drive major reforms in the way that the public service does its business. The Public Service will be smaller, with fewer organisations and fewer staff operating from a reduced number of locations with significantly reduced resources. Because of this, the Public Service will have to be more efficient and effective. It will have to achieve greater productivity and demonstrate greater flexibility. The performance of organisations and individuals will have to be better managed and measured and there will have to be greater accountability for results. Staff mobility will have to be maximised and organisations will have to be restructured so that public bodies and individual public servants will be able to work together across sectoral, organisational and professional boundaries more effectively.

The Government has set out a vision for an increasingly integrated Public Service which is leaner and more effective, and focussed on the needs of the citizen. This vision must be realised throughout

³¹ In exceptional circumstances, critical and urgent business needs may necessitate recruitment to particular posts which cannot be filled through redeployment. In such cases, the organisation will be required to suppress a lower priority post.

every part of the Public Service through the implementation of Government's Transforming Public Services agenda which will be facilitated by the Croke Park Agreement. The commitments given by the Government under the agreement are dependent on delivery of these efficiencies. Unions have agreed that services can be restructured, work locations can change and that services to the public can be offered over longer periods.

The reduction in numbers over the last two years has resulted in increased productivity across the public service. The core concern of Government is to achieve sustainability in the cost of delivering public services through a further targeted reduction in public service numbers. Revised work practices and other major reform initiatives are essential to mitigate the impact on priority public services of staff reductions and limited resources. More must be achieved by fewer staff with smaller budgets.

Croke Park Agreement

- Building on its Statement on Transforming Public Services, the Government has set out a vision for an increasingly integrated Public Service which is leaner and more effective, and focussed more on the needs of the citizen. The Public Service Agreement 2010-14 (the Croke Park Agreement) will facilitate co-operation with the actions which will have to be taken in every public service organisation to achieve the Transformation agenda.
- In the light of the serious state of the public finances, very significant steps have already been taken over the last eighteen months to restrict the cost of the public service.

Pay Reduction

- By accepting the Croke Park Agreement, public servants have accepted the imposition of a pension levy and pay cuts resulting in an average combined reduction of 14% in pay. This has resulted in an estimated annual pay saving of €1.8 billion in net terms. The Agreement provides for an effective freeze in pay up to 2014.

Substantial Numbers Reductions

- As a result of the moratorium on recruitment and promotion and other cost savings mechanisms like the Incentivised Scheme of Early Retirement and the Incentivised Career Break Scheme, there has already been a reduction of about 12,000 in public service numbers since the end of 2008. Under the Croke Park Agreement, the public service unions have given commitments to co-operation with public service modernisation which will include work practice changes that will be necessary to sustain priority service levels with significantly reduced numbers.

Industrial Peace

- Reform measures have been implemented with no substantial industrial unrest.

4.4 Redeployment

Without steps to mitigate their impacts, a substantial reduction of the numbers of public servants would impact on the level and range of services delivered to the public. In this constrained environment it is crucial that there is maximum flexibility in the deployment of staff.

The redeployment arrangements contained in the Croke Park Agreement will allow us to sustain priority services which will include work practice changes that will be necessary to sustain priority service levels with significantly reduced numbers. It will permit staff to be moved from activities which are of lesser priority, or which have been rationalised, reconfigured, or restructured, to areas of greater need.

Redeployment arrangements will apply in the Civil Service; in the Health and Education sectors; in Non-Commercial State Agencies (NCSAs); and in Local Authorities. Redeployment can take place within individual sectors or between these sectors. It will provide Departments and agencies with an effective and efficient mechanism for reducing excess staff numbers and for acquiring additional staff where appropriate, without the need to resort to outside recruitment. In addition substantial changes will be required in work practices as provided for under the Croke Park Agreement.

4.5 Public Service Transformation

Delivery of the Government's Transformation agenda will require tangible and measurable change across all parts of the public service in a number of key areas.

4.5.1 *Performance*

The reduction in numbers will demand significant improvements in performance from all public servants as we strive to maintain service levels with scarcer resources. Performance management and development will be extended across all sectors of the Public Service. Existing systems will be strengthened significantly to ensure that performance ratings reflect actual performance. Performance management will be linked to disciplinary systems.

The proposed Performance Budgeting Initiative, as outlined at Section 3.5, will also be supportive of the performance management agenda.

4.5.2 *Service Delivery*

Services to the citizen can be enhanced as staffing numbers reduce if the manner in which they are delivered is reformed according to the following strategies that have proved successful outside the public service. These include:

- moving to risk based compliance;
- filtering of applications;
- use of trust relationships to obtain data; and
- greater use of self-service including online facilities.

Progress in this area will underpin developments right across the eGovernment agenda.

4.5.3 *Shared Services*

Sharing of services by Public Service bodies will gather pace in this constrained budgetary environment. A Head of Shared Services is being appointed and areas to be targeted include:

- human resource management;
- payroll;
- pensions administration; and
- financial management.

While some initial investment is required, this is an obvious area to deliver significant savings over the lifetime of the Plan.

4.5.4 eGovernment

eGovernment has the potential to improve a whole range of Government services. The current eGovernment Strategy focuses on improved delivery of information electronically, enhanced electronic delivery of services, and better use of shared technology approaches. The eGovernment plans of individual bodies are being developed in accordance with these recommendations.

Further phases of this strategy are being planned. These will address greater electronic integration between public bodies, the online publication of public service data, online collaboration facilities for citizens and businesses, and legal and administrative measures to enhance the take-up of electronic services and self-service.

Further details are contained in Annex 9.

Action Points

Public Service Transformation

- The reduction in public service staffing levels and scarcer resources will necessitate significant reform in order to ensure that priority service levels to the citizen are maintained.
- These reforms can be achieved through the full implementation of the Transforming Public Services agenda facilitated by the Croke Park Agreement.
- Service delivery will be reformed, refined and simplified.
- Greater use will be made of shared services to achieve efficiencies and improve service delivery.
- There will be substantial changes to the way in which public servants work to increase productivity and sustain necessary public services. Performance management and development will be extended across all sectors of the Public Service and existing systems will be strengthened.

4.6 Public Service Sectoral Reform

4.6.1 Civil Service and State Agencies

The Civil Service and State Agencies are treated as related sectors for redeployment purposes, allowing for flexible redeployment between them and other sectors as required.

In the Civil Service increased productivity will be secured from a reduced staff complement through revised working practices, for example in the Prison Service, where all tasks in prisons and places of detention will be reviewed with a view to delivering further staffing efficiencies. Productivity will be

improved by eliminating outdated working and attendance arrangements and by better managing existing human resources and by better managing existing human resources across the Civil Service.

The Programme of State Agency rationalisation that commenced in 2008 will continue. In particular there will be an emphasis on:

- reducing the number and range of agencies;
- redeploying staff to areas of greatest need;
- improving governance and performance arrangements; and
- sharing services.

Agencies will be required to reduce their running costs by 10%.

4.6.2 Health

The Health Service will be reformed to provide a greater range of services in community settings, particularly through primary care teams and social care networks, and to provide such services on a planned basis in the evenings and at weekends. This will lead to a reduction in the number of in-patient beds and an increase in day case, outpatient and diagnostic capacity, which will provide faster access to services at lower cost.

Planned services will be provided throughout the health system over an extended (8 a.m. to 8 p.m.) day and over an extended week, while emergency services will continue to be available on a 24-hour 7-day basis. This will reduce the staffing and other resources required to ensure services are available to the public at nights and weekends.

Staff will be redeployed within and across service locations in the publicly-funded health service, and in the wider public service, as necessary. There will be a review of existing rostering arrangements, to incorporate changes so that staff levels match service demand levels at all times and in all settings.

Health system management will centralise functional, transactional, support and other services at national level including areas such as medical card and other scheme processing functions, payroll, procurement and purchasing, Information and Communications Technology and Human Resource Management.

Major change will be introduced in medical laboratory services and associated work practices. Individual, professional and statutory accountability for management and comparable clinical grades will be strengthened, and performance management will be introduced in the health service in 2011.

4.6.3 Local Government

Significant change is envisaged for the local government sector over the coming years, as set out in the recommendations of the Local Government Efficiency Review. The redeployment arrangements will support this restructuring of local government. Staff will be transferred from areas where demand

has declined, such as planning, to other hard-pressed parts of the local authority or the wider Public Service. Service delivery will be changed to maximise efficiencies and savings will be achieved through regional delivery, the use of shared services, aggregated procurement and online transactions, new work practices and flexibility in working arrangements. Modernisation and standardisation of employment conditions will drive productivity improvements, with the performance management system linked to incremental progression and promotion.

4.6.4 Education

In the Education Sector, a comprehensive review and revision of the contracts for teachers and other education staff (special needs assistants, staff in Vocational Education Committees, Institutes of Technology and Universities) will identify and remove impediments to the provision of an effective service. Teachers and academic staff will work an additional hour per week to provide for a wide range of needs in the various institutions, with the Institutes in particular committed to flexible delivery of new courses specifically aimed at the unemployed. Redeployment will take place at all levels and will facilitate restructuring in the second and third level sectors. The substitution and supervision roster for teachers in second level schools will be improved.

4.6.5 Policing and Defence

A more effective Garda rostering system will ensure that there are enough Gardaí to meet priority policing demands. Civilianisation will maximise the availability of Gardaí for duties of a policing character. Garda training of recruits and serving members will be tailored to meet the diverse needs of a modern police service.

The overall organisation and structure of the Defence Forces is being reviewed. The Defence Forces will cooperate with the flexible deployment/redeployment of personnel.

As public service payroll represents about one third of overall spending, there is significant scope to make major savings. This is a key element of the overall consolidation strategy.

4.6.6 Prison Service

In light of the recent significant increase in the prison population, we are determined to ensure that imprisonment is used only as a sanction of last resort. Prison has to be reserved for serious offenders.

In 2009 there were 4,800 cases where people were sent to prison for non-payment of fine. We have introduced a number of measures to address this in the Fines Act 2010.

- With effect from January 2011, courts will have to take into account the capacity of a person to pay a fine before deciding on the amount. So by law no person should be sent to prison because they cannot afford to pay a fine.
- Later next year, as soon as the Courts Service have the necessary administrative arrangements in place, measures will be brought into force which will allow for fines to be

paid by instalment. In cases where a person wilfully refuses to pay a fine, the first option will not be imprisonment but seizure of their goods and if that proves unsuccessful the courts will consider community service before imprisonment.

A large number of people sent to prison are sent there with sentences of imprisonment of six months or less. Legislation is being drafted and should be published early in the next session that will impose a legal obligation on judges to consider the imposition of community service in cases where they might otherwise impose a prison sentence of six months or less.

Measures have already been taken to stop people being imprisoned unfairly for non-payment of civil debt.

Action Points

Government will achieve savings of €1.2 billion in the Public Service Pay Bill by:

- Cut public service staff numbers by 24,750 over 2008 levels, back to levels last seen in 2005;
- leveraging the mechanisms of the Croke Park Agreement to secure efficiencies in all areas; and
- reducing pay rates by 10% for new entrants.

4.7 Public Service Pension Reforms

Pension costs for public servants will continue to rise over the coming years due to the rise in Public Service employment in the 1970's. As Table 4.4 below shows, an increase of 13% to over €3 billion is in prospect by 2014.

Table 4.4 Expenditure on Public Service Pensions						
	<i>2010</i> €bn	<i>2011</i> €bn	<i>2012</i> €bn	<i>2013</i> €bn	<i>2014</i> €bn	<i>% change</i> 2010-14
Opening Expenditure Level	2.8	2.8	2.9	3.0	3.1	13%
Impact of Retirements		0.2	0.2	0.1	0.1	
Pension Adjustment		-0.1	-0.1	-0.1	-0.1	
Expenditure Ceiling	2.8	2.9	3.0	3.0	3.1	12%

The Comptroller and Auditor General's report on Public Service pensions (Special Report 68, October, 2009) estimated the actuarial cost of public service pensions at €108 billion and pointed to the fact that a change in the indexation arrangements for post-retirement increases could lead to substantial cost reductions in the future.

The Government has decided that a reduction in the cost of Public Service pensions is necessary. Pensions now account for almost 15% of the total Public Service pay and pension bill. This has increased from €1.35 billion in 2005 to €2.8 billion in 2010, an increase of more than 100% over the

period. The Comptroller and Auditor General's (C&AG) 2010 report shows the number of Public Service pensioners increased from 113,384 in 2008 to 123,954 in 2009; the report also estimates that there are two Public Service pensioners for every five serving public servants.

Given the present budgetary constraints, the Government considers that it is appropriate that some retired Public Service pensioners make a contribution to the required adjustment. There is a gap between the burden being borne by those currently in Public Service employment and those who are retired. The pension levy and the pay adjustment did not affect those in retirement. The Government has also taken account of the general reduction in prices: the CPI is now at 2007 levels, whereas Public Service pensioners received general round increases of 2% in June 2007, 2.5% in March 2008 and 2.5% in September 2008 – providing an increase in the real value of Public Service pensions.

The Government has therefore decided on a reduction of €100 million or about 4% in the annual cost of Public Service pensions paid to some pensioners in 2011. The reduction will require legislation to be passed before the end of the year.

In order to avoid a destabilising rate of retirements in 2011 and to manage the cost in both 2011 and 2012, the Government has decided to extend the "grace period" under which pensions are calculated by reference to the pre-cut rates of public service pay to end-February 2012. This decision has been taken into account in the pay and pensions figures presented.

The reduction will apply to existing Public Service pensioners, former office holders, retired members of the Judiciary, and their survivors. For existing public service pensioners and those public servants who retire before the ending of the 'grace period' at end-February 2012, the legislation will provide for an average reduction of some 4% in pensions in line with the following rates and bands:

<i>Annual Public Service Pension (€)</i>	<i>Reduction Rate</i>
First 12,000	0%
Between 12,001 and 24,000	6%
Between 24,001 and 60,000	9%
Balance above 60,001	12%

There is no change in public service pension scheme terms. Pensions will be calculated in the usual way according to those terms. In the case of existing public service pensioners and those public servants who retire before the ending of the 'grace period' at end-February 2012, there will be an average reduction of some 4% in pensions with the application of the above rates. As those who retire after this date are subject to the pay reduction of 7% on average, which will reduce the pension and lump sum to be paid, the Government has decided that it would not be appropriate to also apply the pension reduction to this group.

More generally, public service pensions must be comprehensively reformed so that future costs can be managed in the context of sustainable public finances. In Budget 2010, the Minister for Finance announced the introduction of a new single pension scheme for all new entrants to the Public Service from 2011. This new scheme will reduce budgetary expenditure on Public Service pensions in the longer-term.

This is another step in the reform of the Public Service pension system that has been underway for some time:

- in 2004, the minimum pension age was increased from 60 to 65 years for new entrants to the Public Service;
- in 2009, the pension-related deduction was introduced for all Public Servants in recognition of the benefits provided under Public Service pension schemes; and
- no pension increases are being paid at present.

The main provisions for the new scheme decided by the Government are:

- raising the minimum pension age to 66 years initially and then linking it to the state pension age - this is in step with the changes decided by the Government in the context of the recently announced *National Pensions Framework* which increased the state pension age to 66 years in 2014, 67 in 2021, and 68 in 2028;
- a maximum retirement age of 70 years; and
- career average earnings rather than final salary will be used to calculate pension – a standard accrual rate would be applied to pensionable pay so that a pension amount accrues each year, this amount to be up-rated each year by the CPI so as to maintain its purchasing power.

Legislation will be published shortly facilitating the introduction of the new scheme in 2011.

The new pension scheme which will apply to new entrants from 2011 will use the CPI rather than, as at present, a link to the pay of serving Public Servants to calculate increases for pensioners. This is a major step towards achieving savings such as those identified in the Comptroller's 2009 report. The *Public Service Agreement* provides that use of the CPI for post-retirement increases for existing pensioners and serving staff will be considered as part of the general discussions on pay and other issues in spring 2011. The Government has agreed that no change will be applied to the present pay parity arrangement for existing pensioners and serving staff during the lifetime of the Agreement, that is, up to 2014. In view of the terms of the Croke Park Agreement, that arrangement will not give rise to any increase in that period.

Action Points

In order to address the significant rise in public service pension costs in future years, the Government will:

- Secure a contribution from public service pensioners of €100 million in 2011.

- Bring in a new single pension scheme for new entrants to the Public Service from 2011.

4.8 Social Protection Expenditures

Table 4.5 below sets out the projected rate of expenditure increase in these areas of spending, along with the reductions required for the period to 2014. Spending in this area will be reduced by €3 billion in 2014 when compared with the opening position.

For 2011, scheme savings of €760 million are required from the Social Protection allocation in addition to savings of €100 million from labour activation measures. These measures will be announced on Budget Day. Further savings amounting to approximately €1.9 billion will be required in the period 2012–2014, as summarised in Table 4.5 below. To achieve this level of savings will require a combination of enhanced control measures and labour activation measures which would lead to a reduced Live Register as well as structural reform measures and further rate reductions as necessary over that period. Savings from rate reductions can be ameliorated over the period of the Plan if substantial progress is made with structural reform changes to the social welfare system, re-oriented labour activation measures and also to the extent that the current level of fraud and control activity can be increased through enhanced measures. These would include improved detection methods, better data matching and, overall, an increased use of e-technology. In particular, the roll out of the Public Service Card, from early 2011, will facilitate that process.

Table 4.5 Proposed Expenditure on Social Protection

	2010 €m	2011 €m	2012 €m	2013 €m	2014 €m	% change 2010-14
Opening Expenditure Level	20.9	21.0	20.9	20.8	20.7	-1
Consolidation Objectives						
- Measures from 2011	0.9	0.9	0.9	0.9	0.9	-
- Measures 2012-2014	-	0.6	1.4	1.9	1.9	-
- Total	0.9	1.5	2.3	2.8	2.8	-
Expenditure Ceiling	20.9	20.1	19.3	18.5	17.9	-14

Considerable analysis has been undertaken in reviewing social welfare policy in the areas of child income support and working age payments and, in this regard, three reports will be published shortly by the Minister for Social Protection.

Structural reform measures in these areas could include:

- The development of a rebalanced and integrated child income support payment system. This would provide for a universal component to replace Child Benefit with one single payment rate per child. This payment will be supplemented with a further payment in the case of children of

families in receipt of a social welfare payment or in low income employment. These supplements will replace qualified child payments and family income supplement as appropriate.

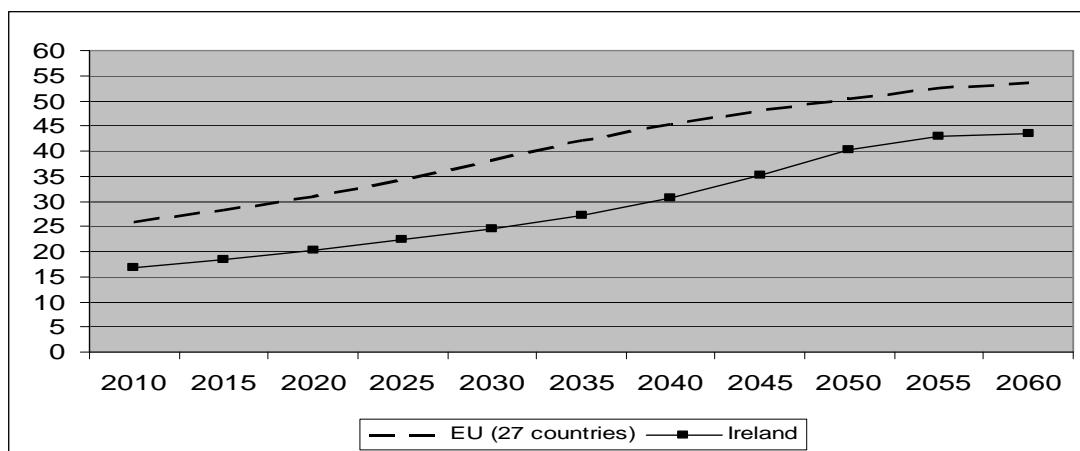
- The development of a single social assistance payment to replace the different means-tested working age payments, including some secondary and supplementary payments, as part of a more purposeful labour activation strategy which will involve:
 - more participation by people in receipt of social assistance working age payments in labour activation measures; and
 - the provision by the State of more personalised labour market measures targeted at all working-age payment recipients who would have previously received one parent family payments, disability payments and jobseekers payments.

The development of such a single working-age means-tested system will help to minimise existing benefit traps and address the lack of incentive to move back to work or move from part-time to full-time employment.

Most EU Members States will have a higher ratio of pensioners to working-age participants over the coming decades – see Figure 4.2 below. While our demographic profile is much more favourable, the ageing of our population means that numbers claiming the State pension will increase over the next number of decades. The projected costs of the State pension out to 2014 are set to increase by about €800 million between 2010 and 2014 or 16%.

These pressures, which will arise over the period of the Plan and beyond, will require some structural change to ensure the sustainability of State pension provision. Funding for the free travel and television licence schemes will be frozen at 2010 levels of expenditure for the duration of the Plan. This decision will have no impact on those benefiting from these schemes.

Figure 4.2 Projected Old-Age Dependency Ratio (%)



Definition: Population aged 65+ as a % of the population aged 15-64. (Source: Eurostat. (Eurostat data is based on EUROPOP2008 convergence)

The Government published the National Pensions Framework in March, 2010. The Framework set out a policy approach for the longer-term development of the pension system in Ireland taking account of demographic changes, the fact that just over 50% of the workforce have private pension provision, the need to provide an adequate income for retirees, and future budget sustainability.

To ensure sustainability, steps must be taken to reduce cost by increasing pension ages and encouraging more saving for retirement. Elements of the new policy proposed in the National Pensions Framework include the following:

- The age at which people qualify for the state pension will be increased - to 66 years in 2014, 67 in 2021, and 68 in 2028.
- A new supplementary pension scheme - using an "auto-enrolment" system - will be introduced to provide additional retirement income for employees not already in a pension scheme. Contributions to the new scheme will be made within a band of earnings, with earnings below and above certain thresholds exempt. Employees earning above a certain income threshold will be automatically enrolled in the new scheme with a contribution rate of 4% within a band of earnings.
- The Government and the employer will support this saving by providing matching contributions.

The Government has made it clear that the introduction of the new supplementary pension scheme in 2014 will depend on economic conditions.

Work on the Framework is going ahead under the aegis of the Department of Social Protection and considerable progress has already been made. While the Government will continue with this work, it is clear that the pace of implementation must have regard to the economic and budgetary circumstances facing Ireland.

Action Points

Social welfare expenditure will be €3 billion lower in 2014 compared to the opening position in 2010.

- Structural reform measures, re-orientated labour activation and enhanced control measures will be required to reduce expenditure.
- Rate reductions will be ameliorated if substantial progress is made with structural reforms and labour activation measures.

4.9 Other Programme Expenditures

4.9.1 Proposed Savings for Other Areas

Seventy per cent of programme expenditures outside of Social Protection are on Health and Education. Table 4.6 shows the multi-annual current expenditure for each of these areas (and for all

remaining spending areas combined) broken down between pay and non-pay³².

Table 4.6 Current Expenditure Ceilings 2011-2014						
	<i>2010 REV</i> <i>€m</i>	<i>2011</i> <i>€m</i>	<i>2012</i> <i>€m</i>	<i>2013</i> <i>€m</i>	<i>2014</i> <i>€m</i>	<i>% change</i> <i>2010-14</i>
Health	14.8	14.1	13.9	13.7	13.7	-8
- pay	7.6	7.3	7.2	7.0	6.9	-9
- non-pay	7.2	6.8	6.7	6.7	6.8	-6
Education	9.2	9.2	9.0	8.9	8.9	-3
- pay	6.4	6.6	6.5	6.5	6.6	+2
- non-pay	2.8	2.6	2.5	2.4	2.3	-16
Other Programmes*	9.8	9.4	8.7	8.2	7.6	-23
- pay	4.6	4.6	4.4	4.2	4.2	-9
- non-pay	5.2	4.8	4.3	4.0	3.4	-34

*Not including social protection.

Although the health and education sectors will be required to contribute to the overall expenditure adjustment, the Government will seek to ensure frontline health services are protected from cutbacks due to the need to provide these services and the importance of human capital as an essential condition for economic recovery. This is in keeping with the consolidation principles set out in Chapter 3.

However, it is also a core principle of the Government's approach to expenditure consolidation that residual savings must be made in the broad area of other programme expenditures outlined in Table 4.6. This will involve closing schemes and programmes which are no longer affordable, and in some case the introduction of fees. This is a more cost effective approach to service delivery compared to a strategy of reducing programme benefits but retaining existing staffing levels.

Details of the specific expenditure measures proposed for these areas for 2011 and for future years are set out in Annex 8.

4.9.2 Scheme for Water Charges

Part of the expenditure savings package will arise from the introduction of a scheme for the metering and charging for domestic water. This will lead to significant capital and current savings to the Exchequer and the General Government Sector over the medium term. This reflects the overall consolidation strategy outlined in Chapter 3 which emphasises the importance of reasonable charging mechanisms to mitigate the costs of public service delivery and reduce waste.

³² A more detailed table showing the gross current expenditure ceiling proposed for each Department is set out at Annex 8. This Annex also details the specific measures proposed for implementation in 2011, and for consideration over the period 2012-2014.

Charging for water will introduce a new revenue stream to meet costs at present funded by taxation. The cost for the provision of water services to the domestic sector in 2008 was €590 million. The proposed charging for this - less an adjustment for the cost of the proposed free allowances - will improve the General Government position. The Exchequer also provided €508m in 2010 to fund capital investment in water services.

It is intended that domestic water charges will cover local authorities' operational costs. A proportion of the capital cost of providing water services to the domestic sector will also be recovered through the charge. Overall it is anticipated that these measures could lead to annual savings of up to €500 million per annum on operating costs with further significant capital savings arising on a graduated basis the following years. These savings will arise as a result of the new revenue accruing from the water charges.

In addition, savings will result from the incentive effects of the metering system which will reduce demand to economically efficient levels over both the short and long term. It is estimated that the value of the operational and capital savings that will accrue in this manner will be significant.

4.9.3 Third Level Education

The Government recognises the importance to society of widespread and equitable opportunities for access to higher education and provides very substantial resources to this purpose.

As well as the wider benefits for society, higher education directly benefits its participants through better lifetime earnings opportunities.

Over the period of the Plan, it is intended that a higher student contribution to the cost of higher education will be made.

Action Point

Government will reduce non-pay expenditure across all programmes excluding social welfare by 2014 through:

- introducing a range of measures necessary to achieve cumulative savings of €3 billion;
- introducing a scheme for the metering of the domestic sector with charging for domestic water by 2014; and
- increase the student contribution to the costs of higher education

4.10 Savings from Reducing the Costs of Public Administration

The reductions now required in public service levels generally, make it imperative that we demonstrate a corresponding resolve to curtail unnecessary administrative costs. While there has been some success over recent years in securing administrative efficiencies, the Government

considers that, in light of the *Transforming Public Service* agenda and of efficiencies calculated to arise under the Croke Park Agreement, it is timely to seek a further significant contribution from this source.

4.10.1 Payroll Savings

Section 4.2 above sets out the proposed savings to be realised from progressive, sustained reductions in public service numbers. In total, these reductions are projected to lead to savings amounting to €1.2 billion, including pension costs, by 2014. This includes reductions in pay-related administration costs in the Health sector and in the Civil Service.

4.10.2 Non-pay Administrative Savings

Proportionate administrative savings should also be factored in for each year of the plan. These savings will amount to €110 million a year by 2014, and include-

- a general 10% reduction in operating costs of Non-Commercial State Agencies (NCSAs) from 2011;
- savings in procurement costs across all areas of public administration; and
- efficiencies in administration in the civil service and wider public service.

Taken together, the overall savings from the costs of delivering public services – both Pay and Non-pay – will come to just under €1 billion a year by 2014. These are included in the programme savings and payroll savings set out in the previous sections.

4.10.3 Procurement

The National Procurement Service (NPS - established in 2009) has among its objectives the procurement of common goods and services across the Public Service, providing professional procurement advice to the Public Service, assisting where appropriate with specialist procurement being undertaken directly by Public Service bodies and integrating whole of Government policy issues (e.g. SMEs, environment, sustainability) in public procurement policy and practice.

The NPS completed a major exercise to identify the areas of top procurement expenditure categories across the public service. This analysis gives the NPS a clear focus on categories of procurement that can be targeted for intervention. To date the NPS has launched major procurement campaigns in a number of areas including energy (gas and electricity), stationery and office supplies, ICT consumables, managed print services, vehicles, clothing and insurance.

The NPS will leverage the Public Service's buying power to obtain better value for money. Last year, savings of €27 million were achieved by public bodies with the support of the NPS. Savings of approximately €40 million have been targeted in 2010. Procurement savings of the order of €50 million are proposed for 2011, rising to €65 million by 2014. The Government has decided to strengthen and focus the current efforts in this area by the appointment of a Public Service-wide Head

of Procurement to help drive a more coherent policy basis and achieve the savings targets required in Public Procurement.

Action Point

- The sum of these measures will yield overall savings in the costs of delivering public services (both pay and non-pay) of up to €1 billion a year by 2014.

4.11 Debt Interest Costs and Debt Management

It is projected that the interest costs associated with servicing the national debt will increase as debt rises. Table 4.7 below sets out the estimated cost, as a percentage of tax revenue, of servicing the interest on the national debt over the period to 2014.

Table 4.7 Debt interest costs, 2011 to 2014				
	<i>2011</i>	<i>2012</i>	<i>2013</i>	<i>2014</i>
Debt interest (as a % of tax revenue)	15	17	19	20

The sale of State assets could reduce the debt interest burden and the Government will be considering the disposal of assets. The recently established Review Group on State Assets and Liabilities will report by end December 2010. This will help to lower the ongoing interest cost.

Ireland has developed significant international demand for its bonds and debt instruments over the years and this international demand will remain an important source of funding as Ireland expands the investor base for its bonds by marketing to new investors. At present almost 85% of Irish bonds are held by overseas investors.

However, a number of measures are also being put in train which will lead to a greater investment in Irish Government bonds by domestic investors.

Irish pension funds have significant assets under management but hold relatively little Irish debt. Proposals have been made to the Government by bodies representing the pensions industry to make certain changes in the legal framework which would encourage pension funds to invest in Irish Government bonds. This will benefit both current and future pensioners as a result of the improvement in the position of their pension funds.

As indicated in a statement last month from the Minister for Social Protection, the Government is currently considering these proposals.

There is also demand in the Irish market from both pension schemes and insurers for a CPI-linked bond. Following further consultation to be undertaken with the markets, the National Treasury Management Agency (NTMA) intends to issue such a bond over the course of next year.

In the stressed conditions which have obtained in the bond markets in recent times, it has been frequently suggested that the State use the resources of the National Pensions Reserve Fund to support the Irish Government bond market. Such a step would be very beneficial to the markets and would demonstrate the Government's willingness to ensure the funding of the Exchequer's needs. Accordingly, legislation will be brought forward to enable the NTMA to deploy the resources of the NPRF to support the Exchequer's funding programme to the extent required. The NPRF's holdings of preference and ordinary shares in Bank of Ireland and Allied Irish Bank will not be affected by this move.

It is also important that ordinary citizens be given the opportunity to invest in Ireland for the benefit of the Irish State. Last year a new Solidarity Bond was announced for this very purpose which was very successful and has raised €300 million since its launch last May. For some investors the investment period of 10 years for the existing Solidarity Bond may be a disincentive. Accordingly, it is intended to launch a new 4 year Solidarity Bond shortly with a similar structure to the 10 year bond. It will pay a coupon each year and a bonus for those who hold the bond to maturity. Further details will be announced by the NTMA in the near future.

The overall amount of funds raised from the retail savings products under the State Savings schemes which are marketed for the most part through the post office network has reached a record €3 billion so far this year. It is expected that those retail savings schemes will continue to perform strongly in 2011.

The Irish public can also avail of the other Government bonds in issue and the various brokers and others through whom the public can purchase these bonds are urged to facilitate the public and to charge reasonable fees.

The initiatives outlined above give an opportunity for the Irish public and pension funds to contribute to funding the national debt. As a consequence of these measures it is expected that there will be a significant increase in the domestic ownership of Irish Government debt in the near future.

Chapter 5 Public Capital Investment

Key Messages

- There has been an unprecedented level of capital spending over the last ten years which has upgraded the quantity and quality of physical infrastructure.
- Planned capital investment must be reduced over the medium-term.
- Annual public capital allocations over the period of the Plan will be progressively reduced to reach an annual reduction of €3 billion by 2013. This is consistent with the lower level of growth and demand in the economy.
- Investment will continue in line with the principles set out in the Government's *Infrastructure Investment Priorities* report and will focus on:
 - Strategic STI investment at the core of the Smart Economy;
 - The Enterprise Development Agencies;
 - Water services investment;
 - Key strategic transport infrastructure;
 - Education capital investment;
 - Energy efficiency supports;
 - Health capital investment;
 - Essential investment in housing infrastructure, including important regeneration projects; and
 - Funding to boost the tourism sector.
- The introduction of water metering by 2014 will start to reduce the level of public capital funding required for water services.
- The Government will identify the opportunity for infrastructure investment by the NPF and other private investors. An appropriate level of investment by the Commercial State Bodies will also assist recovery.

5.1 Overview

Annual capital spending quadrupled between 1997 and 2008 and the infrastructure delivered throughout the period represents a tangible legacy of the economic boom. The infrastructure deficit which previously characterised the Irish economy has been significantly addressed. In particular, the programme of investment has transformed the quality and quantity of the national road network and we now have state-of-the-art motorway connections between Dublin and the main regional centres. The expanded capacity levels achieved in infrastructure overall are likely to be sufficient to meet anticipated demand over the medium term in most areas.

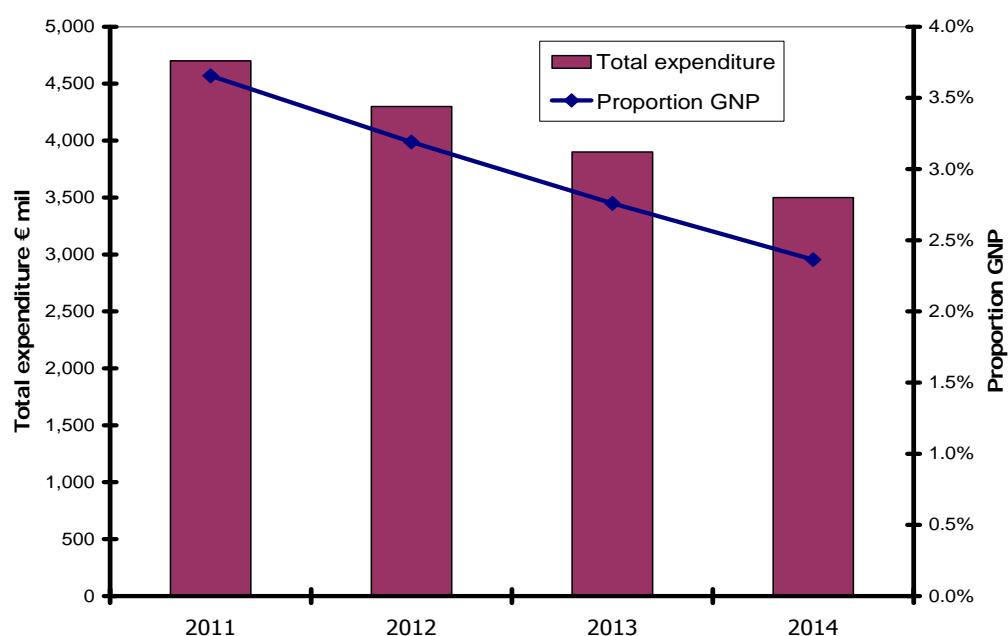
The progress registered in this area in recent years was achieved in the context of a much strengthened public capital investment framework. Successive National Development Plans, the

introduction of multi-annual envelopes and carryover and a renewed focus on project appraisal and management all helped ensure that infrastructure was delivered in a more strategic fashion.

The most recent public capital investment programme was based on a budget of €5.5 billion in each year from 2011 to 2016. Given the need for additional savings, further capital adjustments will be required. Of the total annual cumulative budgetary adjustment by 2014, lower capital allocations will contribute €3 billion.

In addition to the €1 billion of capital savings already identified for 2011 in Budget 2010, there will be a further reduction of just over €800 million to the allocation for 2011. Figure 5.1 illustrates the trend. Investment levels still compare favourably against international patterns and over the period of this Plan will be in line with average government investment as a proportion of national income in the OECD.

Figure 5.1 Revised Capital Allocations, 2011 to 2014



The potential negative effects of these reductions on real economic activity will be contained, however, as the State is now achieving greater value for money in the procurement of infrastructure.

Table 5.1 shows the revised allocations across Departments for 2011-2014. The Government will protect allocations to core economic investment such as supports for enterprise and maintain investment in key social infrastructure such as Health capital.

Table 5.1 Revised Capital Expenditure Ceiling by Vote Group 2011 - 2014					
Vote Group	2011	2012	2013	2014	Total
Agriculture	299	150	140	140	729
Communications	139	110	110	110	469
CEGA	86	86	86	40	298
Defence	12	13	13	12	50
Education	492	460	463	468	1,883
Enterprise	508	558	558	558	2,182
Environment	1,002	966	825	700	3,493
Finance [Excl. OPW]	6	5	5	5	21
OPW	116	120	120	120	476
Foreign Affairs	4	6	6	3	19
Health	399	388	400	400	1,587
Justice Group	80	80	85	85	330
Social Protection	7	7	7	6	27
Tourism, Culture & Sport	96	100	85	80	361
Transport	1,438	1,329	1,075	1,001	4,843
Capital Reserve		0	0	50	50
Unallocated Adjustment		-78	-78	-278	-434
TOTAL	4,684	4,300	3,900	3,500	16,384

Notwithstanding the pressing need to make these adjustments, the Government remains committed to the objectives and principles set out in the Government's *Infrastructure Investment Priorities*. Essentially, these are the investments which make the greatest contribution to economic recovery, underpin the creation of sustainable employment and deliver valuable social infrastructure.

Action point

- The cumulative annual capital adjustment by 2014 will amount to €3 billion commencing with a reduction of almost €2 billion in 2011 and further additional savings of €0.4 million each year from 2012 to 2014.

5.2 Role of Capital Investment in the Economy

Capital investment has been an important driver of economic advancement in Ireland over the past ten years, providing the capacity and scope for growth in national output. By identifying the right investment priorities, capital expenditure can again be central to underpinning economic renewal. Targeted capital investment can achieve this in several ways.

5.2.1 Delivering Economic Infrastructure

Targeted investment in economic infrastructure contributes to economic recovery by reducing bottlenecks, bolstering productivity and facilitating an improvement in international competitiveness. Investment in infrastructure has positive effects throughout the wider economy – for example by reducing firms' transportation and coordination costs. The completion of the Major Inter Urban Routes and a number of remaining national roads projects of key strategic importance will be progressed and will further augment productive capacity in the economy.

Further targeted investment in public transport has the potential to unlock productive capacity in the economy and enhance national competitiveness. Such investment will also offer alternatives to car transport, thereby reducing emissions and enabling the transport sector to cater for the demands associated with longer term population and employment growth in a sustainable manner. Key objectives of public transport investment will be to advance public transport projects like Metro North and Dart Underground, as well as rail safety and traffic management programmes and continued planning of future priorities.

Steps will also be taken to facilitate greater private sector investment in broadband capacity.

5.2.2 Supporting Employment

As discussed in Chapter 3, a guiding principle of the expenditure adjustments set out in this Plan is that future capital investment must be targeted and employment-focused. The primary focus of investment must be on creating the framework conditions in which the enterprise sector can thrive in the medium to long-term. In this regard, public capital investment will have its greatest impact in maintaining sufficient capacity in the economy and supporting productivity enhancements.

The programmes supported by Department of Enterprise, Trade and Innovation and its agencies will be critical in achieving a return to economic growth through promoting the export potential of enterprise in Ireland and advancing the Smart Economy Agenda. These agencies will be flexible and adaptive to the needs of their client base while maintaining the highest standards in investment project appraisal. In addition, future policy will focus heavily on commercialisation of research outputs. Capital investment will therefore support direct job creation in world-class, export-oriented enterprises.

There will also be a level of direct job creation during the delivery phase of valuable public infrastructure. This will assist in retaining a level of employment and expertise in the construction industry. In particular the National Retrofit Programme will give rise to a considerable level of jobs in the construction sector on a nationwide basis.

5.2.3 Development of an Environmentally Sustainable Economy

This Plan provides for programmes of investment in water services, in waste infrastructure, in the National Retrofit scheme and in certain research and development programmes which can assist in the development of a low-carbon sustainable economy.

5.2.4 Investment in Water

Water services investment continues to be a key priority for Government and can deliver significant returns. We intend to prioritise investment in this area to achieve and maintain compliance with various requirements (including those arising from the implementation of the EU Water Framework Directive), to address issues in relation to the condition of water infrastructure in key urban centres

and to meet future demand requirements. Policy in this area is also geared toward reducing the level of water lost through leakages in the distribution network. It is intended that by 2014 this investment will begin to be part funded by water charges.

Water billing for domestic customers will be made on the basis of metered charges. This will require a nationwide project to install meters in domestic residences. The Department of Finance and the Department of the Environment, Heritage and Local Government have been in discussions with the NPRF regarding the funding of the domestic meter installation programme. The NPRF has agreed in principle to fund this programme up to an amount of €550 million subject to certain pre-conditions and in keeping with its commercial statutory remit. It is recognised by Government that a crucial element of implementing this initiative will be the appointment of a Water Regulator.

The intended introduction of water charges by 2014 will start to reduce the level of general government investment required and lead to significant capital expenditure savings.

5.2.5 Delivery of Important Social Infrastructure

The capital allocations set out in this Plan will allow the continued development of social infrastructure, particularly through the delivery of key projects in the education and health sectors and social housing (including regeneration). The stock of educational capital has been very significantly upgraded by investment in school building and maintenance and expansion and upgrading of third level facilities and research space. Demographic developments will exert further pressure on our stock of schools over the coming years. A significant level of funding will be made available to the primary and secondary schools programmes over the medium-term. Given falling land values and tender prices, this funding will make it possible to meet demographic needs and provide for some improvement to the stock of educational capital in real terms. Investment will also build on the already substantial stock of higher education infrastructure.

This Plan provides for the continued modernisation of health facilities to ensure efficient delivery of quality services in the face of demographic factors and a more stringent regulatory environment. All future capital investment in this area will be consistent with broad policy goals in relation to developing capacity in the primary community and continuing care areas and in modernising acute facilities. A substantial level of funding will be maintained into the medium-term. Given the enhanced opportunities for value for money, this will facilitate a considerable upgrade of infrastructure in real terms.

5.3 NPRF Approach to Infrastructure Investment

In May 2010, the NPRF Commission agreed to allocate 5% of the NPRF Discretionary portfolio to infrastructure investment, an increase from the initial strategic allocation of 2%.

The sector's typical investment characteristics of long duration assets with stable yield dominated returns make it highly compatible with the cash flow requirements of a reserve fund such as the NPRF.

The key attractions of the asset class are summarised below:

- Long term horizon.
- Stable cash flows.
- Low volatility.
- Potential for inflation linked returns.
- Increased portfolio diversification.

Operating within the commercial mandate prescribed by its statutory remit, the preferred initial approach of the NPRF is to invest up to €500 million alongside third party institutional investors in infrastructure assets in Ireland. From a Government perspective, this approach offers social and economic benefits that will accrue in Ireland from further investment in infrastructure.

Initially the NPRF envisages this investment will entail the purchase of existing assets and over the medium term may include investing in new infrastructure. The NPRF has agreed to support the water metering programme on commercial grounds. The Government believes that there are commercial opportunities in the area of retro-fitting for the National Pensions Reserve Fund. Public transport investments also represent an opportunity in this context.

Action point

- The Government will help identify public infrastructure investment opportunities for the NPRF and other private investors.

5.4 Investment by Commercial State Bodies

Investment by a range of Commercial State Bodies in particular the State energy companies will also enhance productivity and assist in the process of economic recovery.

In the years 2010 to 2014, capital investment by the ESB will be over €6 billion. This investment will prioritise:

- Reinforcement and modernisation of Distribution Networks .
- Strengthening and adding capacity to the Transmission Network by Eirgrid.
- Smart Grid, Smart Meter and Electric Vehicle infrastructure.
- Renewable Power Generation.
- Existing Renewable/ Energy Efficiency Initiatives.

Bórd Gáis will invest in the region of €1.3 billion which will target:

- Extension of its transmission and distribution natural gas network.
- Developing new renewable wind generation assets.
- Continuing to build a vertically integrated energy business.
- Increased activities in Research and Development.

Eirgrid will also make the substantial investment of €600 million in the East-West Interconnector which is on schedule for completion by 2012.

As noted in Chapter 2, these investment plans will be continuously critically assessed in order to avoid excess capacity and excessive cost.

Considering the progress made in overhauling the national stock of infrastructure in recent years and the greatly enhanced value for money available in capital investment at present, a considerable level of investment can be delivered while still making significant Exchequer savings over the course of this Plan.

Chapter 6 Taxation Measures

KEY MESSAGES

- Revenue measures will provide one third of the budgetary adjustment.
- 40% of total revenue measures will be adopted in 2011.
- The income tax system is unsustainable if 45% of tax units pay no income tax.
- Radical base broadening across the tax system is needed.
- All taxpayers must contribute.
- By overhauling tax expenditures, those that can afford to pay more will pay more.
- Tax policy emphasis must be on sustainable structural reform.
- Funding of local service provision must be addressed.
- The Government will maintain the 12½% rate of corporation tax.
- Supports for small and medium enterprises will be reformed.

6.1 Introduction

The primary function of the tax system is to provide the resources to finance public expenditure. Taxation policy can also be used to incentivise growth, promote income and wealth redistribution and address social and environmental concerns. An efficient tax system must seek to minimise compliance costs and collection costs, while targeting tax avoidance and evasion.

The tax system of the future must be capable of raising the resources necessary to meet public demands in a manner that does not unduly impede economic development and maximises our economic growth potential. An economy that performs well also generates the resources necessary to meet policy ambitions. Decisions on taxation must take account of their economic effects and, as far as possible, must not weaken our ability to grow.

For this reason this Plan places two thirds of the required adjustment on expenditure (€10 billion) and one third of the adjustment on extra revenue principally through taxation (€5 billion). It is broadly accepted that this distribution of the burden of adjustments is less damaging to our future economic prospects than if it were more heavily placed on taxation.³³

6.2 Approach

In raising the revenue necessary to underpin the overall Plan, revenue stability is important. All the measures must be credible; they must structurally reform aspects of the tax system and they must minimise distortions or undue impediments to economic recovery.

³³ "Macroeconomic Effects of Fiscal Consolidation" by Daniel Leigh, IMF, 2010.

Revenue is generated by economic activity, not by increased tax rates. High tax rates and a narrow base of economic activity may raise far less revenue than lower rates on a much wider base. Accordingly, this Plan is concerned not just with the “*quantity*” of revenue to be raised but also with the “*quality*” of the measures adopted and their ability to deliver sustainable structural reforms. At the end of this process we must have confidence that we have a revenue system that is fit-for-purpose.

For these reasons, there must be an emphasis on base broadening across the tax system.

- We must increase the numbers paying tax. An income tax system where more than 45% of tax units pay no income tax is not sustainable.
- Tax expenditures and reliefs must be abolished or restricted: higher earners can not shelter themselves from paying their fair share of tax.

By broadening the base at both ends of the income spectrum, the nominal rates of tax can be kept lower while the effective rate can be raised in a way that is fairer to all.

We must strive to be fair. But we must also confront the pervasive structural problems of the income tax system and recognise that excessively high marginal tax rates damage economic activity.

Finally, it is important that we look at revenue raising measures across all areas – income, capital, indirect, expenditures, reliefs and incentives. The Government remains steadfastly committed to the maintenance of our 12½% corporate tax regime as the cornerstone of industrial policy. Research by the OECD³⁴ points to the importance of low corporate tax rates to encourage growth. In ranking taxes by their impact on economic growth, corporate tax was found to be most harmful. In other words, governments seeking additional tax revenues would be advised to consider increasing all other types of tax (property, consumption and income) before increasing corporate taxes.

6.3 Objective

The objective of the revenue raising plan is to introduce a set of measures that will increase Government revenues by some €5 billion or approximately 3% of GDP in 2010 terms. It is intended that approximately 40% of the policy adjustments will be front-loaded into 2011 with a heavy emphasis being placed on the structural reform of the income tax system.

The table below summarises the main revenue increases over the period of the Plan. A more detailed breakdown is set out in Annex 10.

³⁴ Reference: 'Tax and Economic Growth', OECD Economics Department Working Paper No 620 July 2008

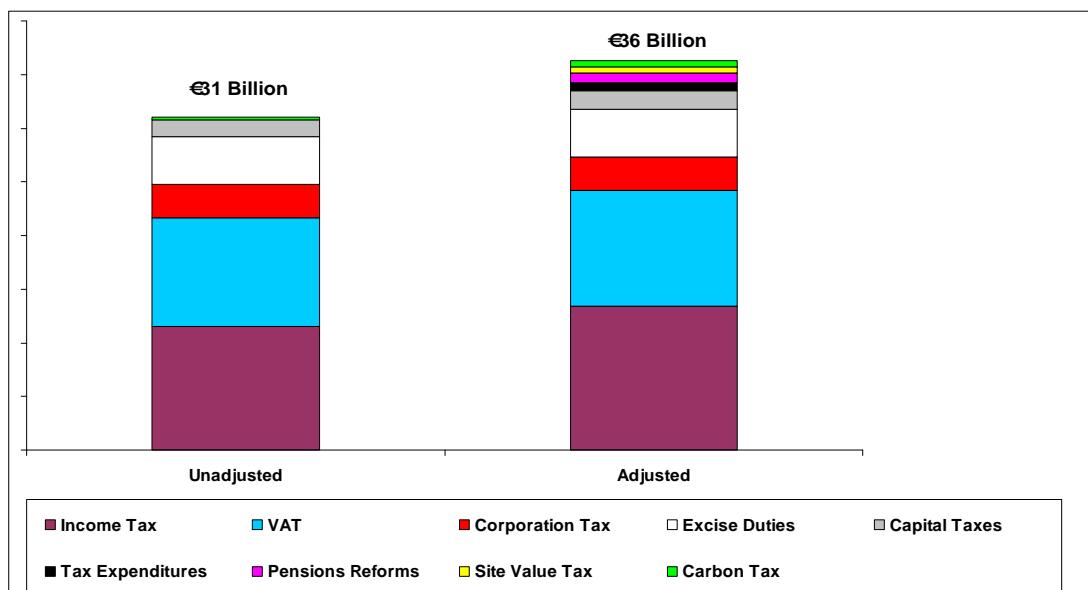
Table 6.1 Taxation Measures

	2011 €m	2012 €m	2013 €m	2014 ³⁵ €m	Total €m
Income Tax	1,245	260	210	160	1,875
Pensions	260	225	225	155	865
Tax Expenditures	405	100	100	60	665
Site Value Tax	-	180	175	175	530
Carbon Tax	-	220	-	80	300
Capital Tax	-	145	-	-	145
Value Added Tax			310	260	570
Other Measures	110	-	-	-	110
TOTAL:	2,020	1,130	1,020	890	5,060

This programme means that approximately one third of the total adjustment will fall on indirect/capital/charges, direct income tax and tax expenditures (including pensions) respectively.

With some two thirds of the total tax increases coming from sources other than direct tax (income or corporate), the Plan's overall objective is to minimise the impact of the adjustment on future economic prospects. The direct income tax increases make up just over 12% of the total budgetary adjustment of €15 billion.

Figure 6.1 Composition of Tax Adjustment, 2010 Basis

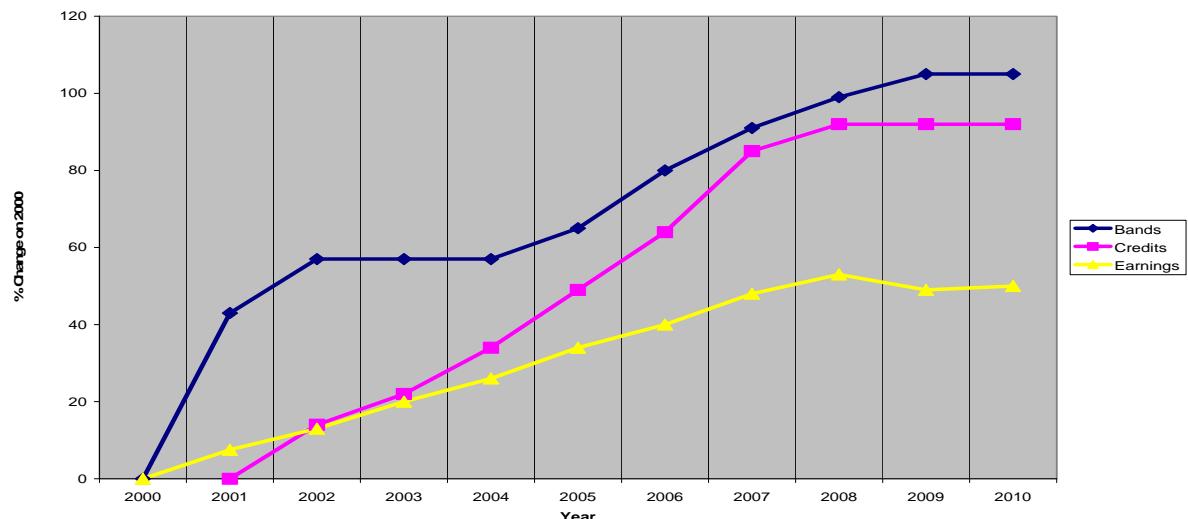


6.4 Income Tax

We have eroded the income tax base to an unsustainable level. This must be rectified if revenue-raising capacity and fairness are to be restored. During the period after 2000, the entry point to income tax increased from €7,238 to €18,300 and since the introduction of individualisation, bands widened by 105% for the single person and married two earners while credits increased by 92% since their introduction in 2001.

³⁵ Additional revenue of just under €300 million will be carried over into years after 2014 and will be fully realised by 2017.

Figure 6.2 Changes in Credits, Bands (single) & Earnings 2000 - 2010



The proportion of tax units exempt from income tax has increased from 34% in 2004 to an estimated 45% in 2010. At the same time the proportion paying at the higher rate has fallen from 23% to just 13% due, in part, to falling incomes.

Table 6.2 Distribution of Income Earners 2004-2010

	2004	2005	2006	2007	2008	2009 Est.	2010 Est.
Total	2,013,701	2,174,999	2,370,732	2,489,108	2,459,240	2,287,202	2,214,300
Higher	23%	21%	18%	16%	16%	14%	13%
Standard	43%	43%	43%	42%	42%	42%	42%
Exempt	34%	36%	39%	42%	42%	44%	45%

The overall burden and incidence of income taxation has increasingly fallen on a relatively small number of taxpayers. In 2010 we have reached a point whereby just 8% (earning €75,000 or more) will pay 60% of all income tax while almost 80% earning €50,000 or less contribute just 17% of income tax.

Had bands and credits evolved in line with wage developments, the amount of revenue raised from income tax, all other things being equal, would now be of the order of 1.5% of GDP higher than it is now. The measures in this Plan will be the equivalent of a reduction of 16.5% in the value of the credits and bands. It will rebase the income tax system at approximately 2006 levels.

It is, of course, possible to deliver the same outcome through a combination of measures including changing the tax rates themselves or restructuring PRSI and the associated levies on income. These options will feature in the Government's consideration of specific changes in advance of each Budget. But however delivered, the Government is committed to achieving the targeted direct income tax increases over the four years.

Over the course of this Plan it is intended fundamentally to reform the income tax system. The merging of the income levy, the health levy and PRSI into a Universal Social Charge was signalled in Budget 2010. The proposed wide scale abolition of reliefs and incentives (see below) will also facilitate the progressive rationalisation of how we tax income by more clearly aligning the income base for each charge. This will enable movement to a unitary income tax system and facilitate the closer integration of tax and social welfare over the Plan period.

Action Points

- Measures raising €1.9 billion equivalent to a reduction of 16.5% in the value of the credits and bands will be delivered over the Plan period.
- Fundamental reform of the income tax system and closer integration of tax and welfare.
- Approximately 65% of the total income tax adjustment to be delivered in 2011.

6.5 Pensions Tax Expenditures

The total gross tax cost of pension tax relief is just over €2.5 billion. Exemptions relating to PRSI and the Health Levy cost an additional €250 million or so. Public discourse about the cost of pension tax relief has been ill-informed and tends to distort the expectations of the savings that could be delivered by adjusting these reliefs.

There are three significant elements in the estimates of the cost of tax and PRSI/Health Levy reliefs for private pension provision as outlined in the Green Paper on Pensions. These are:

- i. the estimated costs of tax relief on employee/self-employed/individual contributions to pension savings (over €1 billion),
- ii. the estimated cost of the tax exemption for employer contributions as Benefit-in-Kind (BIK) in the hands of employees (about €500 million),
- iii. the estimated cost of exempting from tax the accrued income and gains growth of pension funds (about €1 billion).

Reducing income tax relief on pension contributions to the standard income tax rate would only impact on employee/self-employed/individual contributions to pension savings and the full year saving from this would amount to about €500 million. Abolishing tax relief on employee/individual contributions would save the Exchequer about €1 billion in a full year. None of these reforms takes account of the behavioural change which would likely result from tax changes of this magnitude.

The estimated cost of tax exemption on the accrued income and gains of pension funds is a "*notional or imputed*" cost. It is in effect deferred income tax – the fund rolls up gross to provide a higher pension value which is then taxed in the hands of the pensioners as the pension is paid. Imposing an actual tax charge on pension fund growth would not yield anything like €1 billion and would effectively reduce the pension in the hands of the pensioner and the tax take at that point. Furthermore,

removing the BIK exemption from employer contributions to occupational pension schemes would remove the rationale for making those contributions in the first place from the point of view of the employee.

It is not the case that only those on higher incomes benefit from pension relief. The bulk of employee/individual pension contributions attract tax relief at the marginal or 41% tax rate. This is reflected in the fact that individuals on gross earnings of not much over the average industrial wage and contributing to a pension arrangement benefit from tax relief at 41%. Some studies have suggested that the current tax arrangements are most beneficial to those on earnings of about €45,000 per annum (Life Strategies, May 2008).

The abolition of employee PRSI and Health Levy relief would bring the treatment of pension contributions in this area into line with the Income Levy treatment. Equity of the existing tax arrangements could be improved by further downward adjustments to the annual earnings cap for pension contribution purposes and to the maximum allowable lifetime limit for a tax-relieved pension fund (the Standard Fund Threshold – SFT), both adjustments would impact on higher earners.

The Plan provides for the elimination of employee PRSI and Health Levy relief on pension contributions in 2011. It also commits, among other changes in 2011, to reducing the annual earnings cap for employee/personal pension contributions by almost 25% from €150,000 to €115,000 and to reducing the SFT. These measures combined will yield approximately €200 million in a full year. Over the following 3 years of the Plan the rate of income tax relief on pension contributions will be reduced from 41% to 34% in 2012, to 27% in 2013 and 20% in 2014. This will yield an average additional €165 million in each full year giving an overall cumulative reduction in pension tax expenditures of €700 million. In addition, a consequential reduced rate of relief on the public service “pension-related deduction” will yield a further €240 million in a full year.

The abolition of employee PRSI and Health Levy relief and the reduction to standard rate tax relief on pension contributions may reduce saving for private pension provision. However, the Government is committed to raising €700 million from this sector over the period of the Plan and is willing to engage with the industry to examine alternatives to deliver this outcome. Pensions tax expenditures will be kept under constant review to ensure that abusive tax sheltering does not take place.

Action Points

- A €700 million full year reduction in pension tax expenditure and €240 million on relief for the public service “pension-related deduction”.
- Removal of PRSI and Health Levy relief on pension contributions in 2011.
- Reduction in the annual earnings cap of 25% in 2011.
- Phased standard rating of income tax relief over 2012, 2013 and 2014.

6.6 General Tax Expenditures

In the same way as there are unrealistic expectations about what pension tax expenditures can contribute to budgetary correction there is a poor understanding of the scale of tax expenditures/incentives generally. Commentators often conflate tax expenditures in general with property based tax expenditures in particular and with those elements of revenue foregone that are the fabric of the income tax system.

There is frequent reference to the OECD proposition that by 2005 the cost of "*tax expenditures*" had become larger than the remaining income tax receipts. The figure published by the OECD put the value of tax expenditures at €11.49 billion. An analysis of these figures shows that:

- 80% or €9.72 billion of all the tax expenditures relate to personal allowances/credits/bands, pensions and savings;
- Of the remainder, 'interest relief' at €350 million and some portion of the €980 million for "social schemes" (urban/rural renewal etc) relate to property; and
- This leaves a balance of approximately €440 million in miscellaneous tax expenditures/incentives on the basis of the OECD estimate.

Most public commentary on this issue either misunderstands or ignores how these "expenditures" are broken down. Indeed, the Commission on Taxation did not regard a very large part of these costs to be tax expenditures, but rather part of the fabric of the income tax system (bands, allowances, personal credits)³⁶.

The tax costs associated with pensions and personal allowance/bands/credits, which make up 80% of the estimated expenditures, have been addressed earlier.

Interest relief on residential mortgages was abolished in Budget 2010 with a gradual phasing out of mortgage interest relief (MIR) up to end of 2017. Loans taken out on or after 1 January 2013 will not qualify for MIR and the relief will be abolished completely for the tax year 2018 and subsequent tax years. The full year saving will be €485 million. Any acceleration of the withdrawal of interest relief would place unacceptable financial pressures on households with the highest risks of being in negative equity. Any move in this direction would increase the risk of default. There will be no change to current arrangements.

Budget 2006 announced the termination, subject to certain transitional provisions, of Urban Renewal; Town Renewal; Rural Renewal; Accelerated Capital Allowances for Hotels; Capital Allowances for Holiday Cottages; Student Accommodation; Multi-Storey Car Parks; Third-level Educational Buildings; Sports Injuries Clinics; Park and Ride Facilities and General Rental Refurbishment Schemes.

³⁶ Page 11, Commission on Taxation Report.

Transitional arrangements provided for an extension of the deadline to 31 July 2008 for projects already in the pipeline where planning application conditions had been met. In addition, the amount of capital allowances available would be reduced to 75% in 2007 and 50% in 2008. Since 2006, most of the remaining property reliefs in the health and childcare areas have been abolished with similar transitional arrangements.

Given the structure of these schemes there are ongoing legacy costs as investors use their capital allowances. Those legacy costs will reduce with time as capital allowances are exhausted. The restriction of reliefs measure introduced in 2007 (and further enhanced in 2010) also curtails the ability of individuals to utilise these reliefs, thereby spreading the costs over a much longer period.

In current circumstances, it is no longer acceptable that measures abolished as far back as 2006 should continue to cost almost €400 million per annum. Accordingly, the Government is committed (in line with the Revised Programme for Government) to the phased abolition of these legacy reliefs over the period of the Plan.

As regards other tax expenditures, the Plan provides for the abolition of ten tax expenditures and the curtailment of a further six in Budget 2011. Over the remainder of the period 2012-14 tax expenditures will be kept under constant review with a view to further eliminating them from the tax system.

The measures to be abolished in 2011 are:

- 1 Tax exemption for patent royalties.
- 2 The investment allowance for machinery and plant and for exploration expenditure.
- 3 Approved Share Options Scheme.
- 4 BIK exemption on employer provided childcare.
- 5 The accelerated allowance for capital expenditure on farm buildings for pollution control.
- 6 The tax exemption for payments to National Co-operative Farm Relief Services Ltd.
- 7 Income tax relief for rent paid for private rented accommodation.³⁷
- 8 Income tax relief for trade union subscriptions.
- 9 Income Tax Age Credit (phased over 4 years).
- 10 Income Tax Age Exemptions (phased over 4 years).

These measures will yield an estimated €280 million in a full year.

³⁷ Phase out on same timeline as MIR.

A further six expenditures will be curtailed or otherwise restricted as follows:

- 11 PRSI, Health and Income Levy charge on Approved Profit Sharing Schemes.
- 12 PRSI, Health and Income Levy charge on Approved Save-As-You-Earn Schemes.
- 13 PRSI, Health Levy charge for Unapproved Share Options.
- 14 PRSI, Health Levy charge for Share Awards.
- 15 Artist's exemption from Income Tax (Restrict exemption to €40,000 earnings).
- 16 *Ex-gratia* termination and pension lump sum payments in excess of €200,000 to be taxed.

These measures will yield an estimated further €75 million in a full year.

Action Points

- A €755 million full year reduction in general tax expenditures.
- Some €355 million of income tax expenditures will be abolished/curtailed in 2011.
- Legacy costs associated with property based incentives worth €400 million will be phased out over the period of the Plan.
- Expenditures will progressively be reviewed and removed from the system.

6.7 Value Added Tax and Indirect Tax

The level of indirect tax in Ireland is higher than average, with excise duties being especially high. Notwithstanding this, it is accepted that increases in indirect tax are less economically damaging than direct tax increases as they affect consumption rather than production.

Cross-border trade risks are now less than they may have been in the recent past. VAT rates have increased across Europe in response to the current crisis with some 23 Member States now having rates of 19% or more (including the UK who will be at 20% from 4 January 2011).

Accordingly, it is intended to increase the standard rate of VAT from 21% to 22% in 2013 with a further increase to 23% in 2014. The lower rate on labour intensive services will be left unchanged as any increase could harm employment. The Government will also examine further rebalancing of the VAT system and zero rated VAT items within the context of wider and ongoing EU level consideration of the matter.

In addition to this, a number of changes will be made to excise duties and licences in 2011 to the value of €110 million.

Action Points

- Standard rate of VAT to be increased by 1% in 2013.
- A further 1% increase in the standard rate of VAT in 2014.
- These VAT measures will increase yield by €620 million in a full year.

- Zero rated VAT items to be reviewed as part of EU level consideration.
- Miscellaneous 2011 excise measures amounting to €110 million in a full year.

6.8 Financing Local Services

One of the fundamental challenges we face is to put the funding of locally delivered services on a sound financial footing, to improve accountability and to better align the cost of providing services with the demand for such services.

The Plan commits to a funding platform for local Government on a phased basis. An interim Site Value Tax will be introduced in 2012, applicable to all land other than agricultural land and land subject to commercial rates. The interim measure will involve a fixed local service contribution of about €100 per annum (€2 per week) which will raise €180 million from households. The final Site Value Tax will be introduced in 2013 when valuations have been completed.

It is estimated that Site Value Tax will apply to 1.8 million households and zoned lands that would equate to an estimated further 700,000 houses. At an average of just over €200 per dwelling (or site) this would raises the €530 million full year amount targeted for the Plan period.

For full implementation of the tax, commercial rates will be moved to a site value basis also.

These measures will have significant implications for the financing of local authorities, including a lower contribution from the Exchequer and from motor tax revenues.

The Government revised the vehicle registration tax and motor tax systems on cars to be based on the CO2 emissions of the vehicle, rather than on engine size, with effect from 1 July 2008. This change has been highly successful in encouraging people to purchase lower emissions cars. However, the change in purchasing patterns, combined with other factors, is having an impact on revenue yields, especially in the case of motor tax over the medium term.

During the Plan the current CO2 bands and rates structures will be examined in the light of the overall reductions in CO2 emission levels being made by car manufacturers and the standards set internationally with a view to adjusting the bands in line with technological advances on 1 January 2013.

Action Points

- A Site Value Tax will be introduced in 2012 and completed by 2013
 - An interim fixed “household charge” of €100 per annum in 2012.
 - A full value-based addition will be introduced in 2013.
- These measures will yield €530 million in a full year.

6.9 Carbon Tax

The economic and social implications of climate change are immense and it is the responsibility of Governments everywhere to change behaviour to reduce our greenhouse gas emissions. The most effective way to achieve this is to put a price on carbon. This will encourage innovation by incentivising companies to bring low carbon products and services to the market. Accordingly, a carbon tax was introduced at a rate of €15 per tonne in the 2010 Budget.

But changing behaviour takes time. It is important to reinforce and encourage behavioural change through a gradual and progressive upward adjustment in the price penalty associated with the consumption of carbon.

It is proposed that over the period of this Plan the price of carbon will be doubled to €30 per tonne thereby contributing €330 million to the overall correction. This will entail a €10 per tonne increase in 2012 and a further €5 per tonne in 2014.

Carbon taxes will be a feature of economies across the world in the coming years. At a time when national Budgets are under pressure, it makes sense to choose tax options that can have external benefits such as reducing import dependency, reducing emissions and driving innovation.

A rate of €30 per tonne at the end of four years confirms Ireland's commitment to pricing carbon at a rate that can have positive and lasting domestic benefits and contribute to lowering Ireland's share of global emissions that remain a risk to future generations.

Action Points

- The price of carbon will be doubled over four years.
- The price will be progressively increased from €15 to €30 per tonne.
- These measures will yield €330 million.

6.10 Capital Taxation

In recent Budgets the rates for Capital Gains Tax (CGT) and Capital Acquisitions Tax (CAT) were increased from 20% to 25% and the DIRT rate now stands at 25% and 28% for savings products with less frequent payment of interest.

The Plan envisages that this process will continue. The base for CGT and CAT will be broadened while the level of reliefs and exemptions for these taxes will be reduced. In 2012, the current single CGT rate of 25% will be changed to a system of differing rates for different levels of gains. A similar system will be introduced for CAT where the current tax-free thresholds will be reduced to reflect the fall on asset values over recent years and the very generous nature of these thresholds.

In line with the commitments on tax expenditures in this Plan, reliefs and exemptions from CGT, CAT and Stamp Duty will either be abolished or greatly restricted to ensure that there is an adequate base for these taxes and that all of society makes a fair contribution to the correction of the public finances. A cautious estimated yield of just €145 million is included given the uncertainty of current market conditions and asset price values generally.

Action Points

- The structures and thresholds in the CAT and CGT systems will be reformed in 2012.
- A range of capital tax expenditure will be curtailed.
- These measures will yield €145 million in a full year.

6.11 Corporation Tax

The Irish Government's position on corporation tax is unambiguous. The Programme for Government clearly states that the Government *guarantees that the 12½% rate of corporation tax will remain*. Nothing is changed by this Plan. That commitment is protected, in an EU context, by the principle of unanimity in taxation matters.

While taxation has to play a part in restoring balance to our public finances, this will not apply to our corporation tax rate. A low rate of corporation tax on export-orientated activity has been a cornerstone of our industrial policy since the 1950s and the 12½% rate is now part of our international 'brand'. The contribution from the corporate sector will be made through the maintenance and creation of high value employment.

The Commission on Taxation recommended that "*a low stable corporation tax rate should remain a core aspect of Irish tax policy to support economic activity in the long term*". Ireland's low corporate tax rate is based on an open and transparent system that does not discriminate based on company size or ownership. It is a low tax rate applied to a broad base. Over one thousand manufacturing companies in Ireland are already experiencing an increase in their corporation tax rate from 10% to 12½% as the transitional provisions of the 10% manufacturing rate of corporation tax come to an end in 2010.

The Government's commitment to the maintenance of a competitive and transparent corporate tax offering has been steadfast over the last three years. Notwithstanding the very real challenges, we have continued to evolve the regime to support the knowledge economy.

We have used the tax system to support research and development, the acquisition and exploitation of intellectual property, new start-up companies and to improve corporate energy efficiency. We have also maintained our competitive position in International Financial Services. These changes have resulted in continued investment in Ireland by multinational companies that see this country as a good place to do business. We will continue to work with business for the delivery of the employment that

will be the lifeblood of our economic recovery thereby copper-fastening our ability to meet our financial obligations as a State.

Action Point

- There will be no change in the 12½% rate of corporation tax.

6.12 Small and Medium Enterprises

The importance of the role of small and medium sized enterprises in Ireland's economy cannot be overestimated. They supply goods and services on which larger companies rely. Small firms directly support 700,000 jobs.

Over the last two years the Government has placed support for this sector at the heart of its strategy for economic recovery.

Government is investing in small firms in their earliest stages of development via Enterprise Ireland's €175 million seed and venture capital programme and through the €500m Innovation Fund.

The Business Expansion Scheme has been operating for 26 years but funds raised under the Scheme since 2008 have declined significantly and businesses have complained that the Scheme is too administratively complex. For these reasons, the Government has decided, subject to European Commission approval, to transform the old BES Scheme into a new and better-focussed Business Investments Targeting Employment Scheme (BITES).

A simple and efficient certification process will be introduced. The maximum amount that can be raised by companies in a 12 month period will be increased significantly, as will the lifetime amount that can be raised per company.

In addition, some of the money raised from abolishing tax expenditures will be redirected to support enterprise.

Action Point

- A new "Business Investment Targeting Employment Scheme" will be introduced in 2011 to replace BES.

6.13 Impact of the Main Income Tax changes

The impact of this Plan on personal income is set out below. The calculations are based on the technical assumption that the main adjustment will be made through reductions in personal tax bands and credits. As discussed elsewhere, this could also be delivered by alternative means with different results.

(i) Entry Point to Income Tax

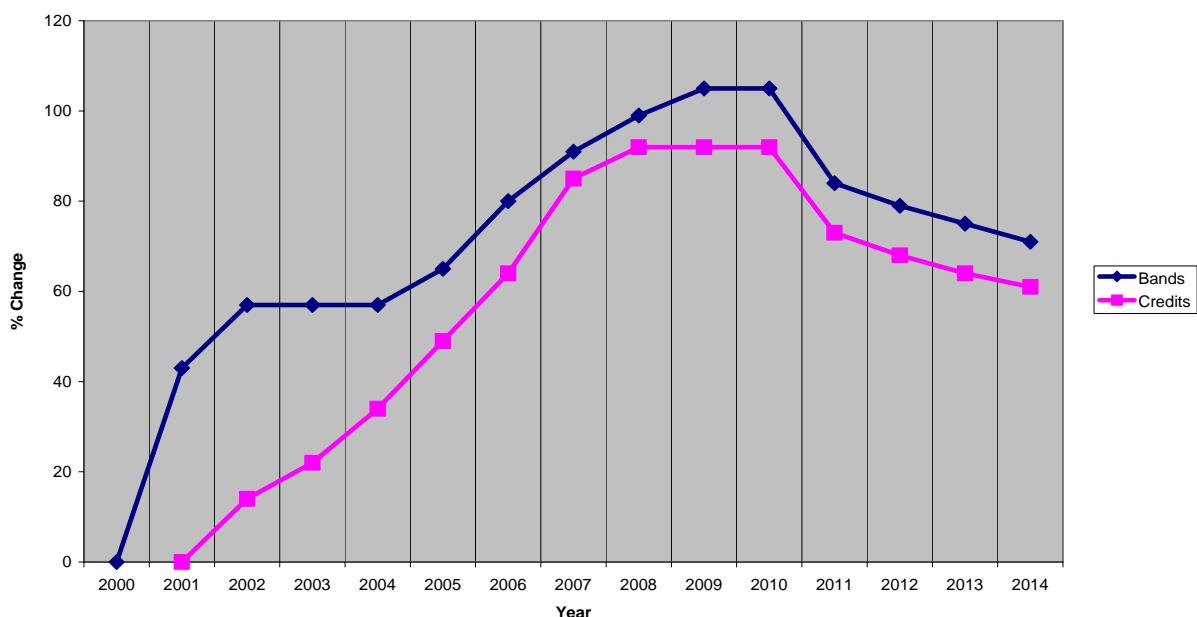
An aggregate 16.5% reduction in the value of bands and credits will reduce the entry point to Income Tax for a single PAYE person to approximately €15,300, a fall of €3,000 from €18,300 in the 2010 tax year by 2014.

(ii) Net Pay

By 2014, net pay for a single person on €55,000 will be reduced by €1,860 per annum (€36 per week) or 4.8%. The net pay for a married one-income family on €55,000 will be reduced by €2,310 per annum (€44 per week) or 5.4%.

For those making tax relieved pension contributions, net income would fall a further 2.5% at this income level in the private sector.

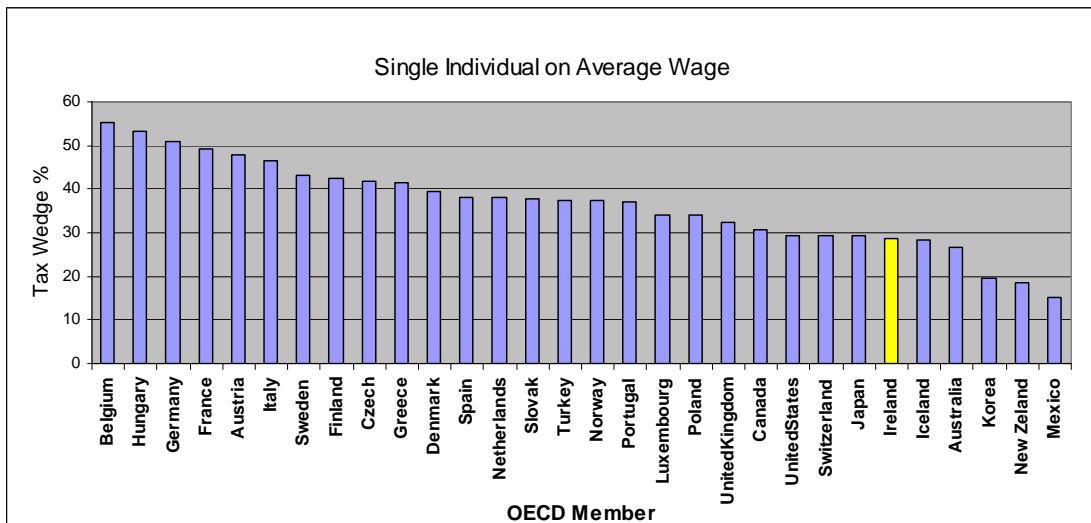
Figure 6.3 Changes to Credits and Bands (single) from 2000 to 2014 (proposed)



(iii) Tax Wedge

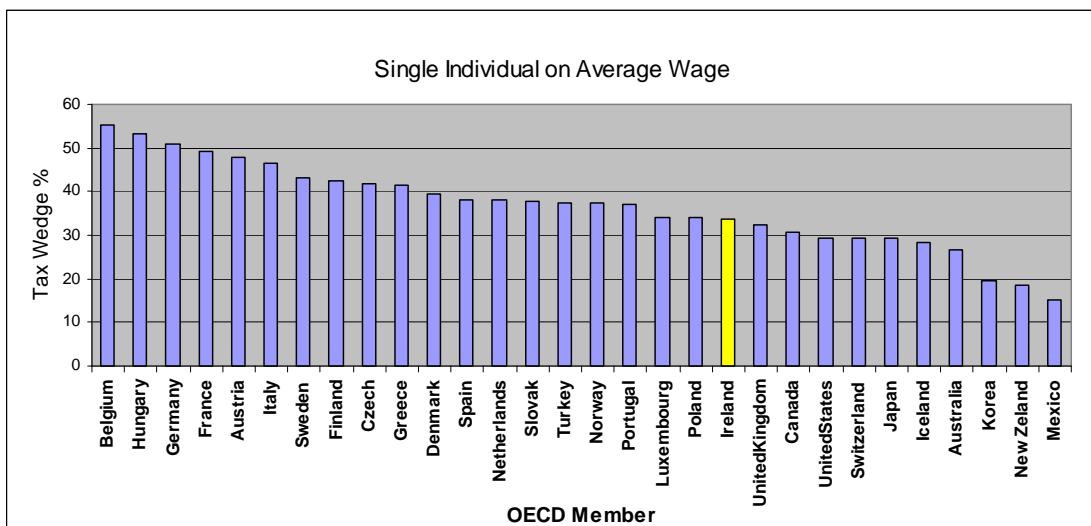
The overall tax wedge on average earnings for a single individual will increase from 28.6% in 2009 to 33.7% by 2014.

Figure 6.4 Comparison of Tax Wedges of OECD Member 2009



As a result, Ireland will move from its 2009 position as sixth lowest tax wedge in the OECD to eleventh lowest. Ireland will have the second lowest tax wedge of the EU members of the OECD from its 2009 position of lowest tax wedge.

Figure 6.5 Comparison of Tax Wedges of OECD Member 2014



This possible outcome assumes, of course, that there are no income tax changes in the tax systems of other OECD and EU members between now and 2014.

(iv) Marginal Tax Rates

Over the 2010-14 period of the Plan, the top marginal rates would remain the same at 52% for PAYE workers and 55% for self-employed.

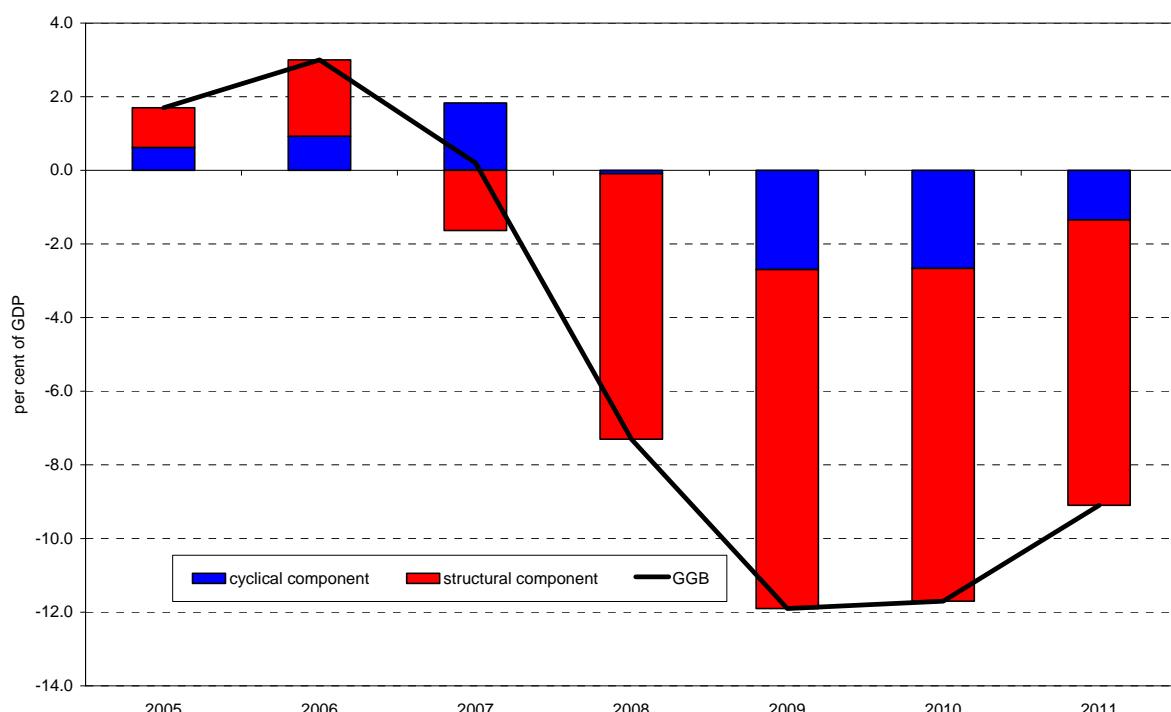
Annex 1

Macroeconomic and Budgetary Data The Structural Balance

The structural budget balance is typically the main target of budgetary policy. This is the balance which would prevail if transitory elements in net Government lending arising from economic fluctuations are removed. Thus, at the current juncture, the structural deficit is the permanent component of the headline deficit that will not be eliminated by economic recovery. It is this structural deficit that policy should seek to eliminate.

Unfortunately, decomposing the deficit into its permanent and transitory components is subject to considerable uncertainty, as neither of these can be measured directly and must be estimated, and all approaches are subject to at least some limitations, especially for an open economy such as Ireland. With this in mind, the headline balance is decomposed into its cyclical and structural components in the figure below; the methodology is based on the harmonised approach developed by the EU Commission and the Member States.

Figure A.1.1 The Structural Balance*



*The structural balance excludes once-off items.

Annex 2

Macroeconomic and Budgetary Data

Economic Tables, Technical Analysis, Risks and Sensitivity Analysis

Risks to the Outlook

The current economic environment remains surrounded by considerable uncertainty, both at a domestic and global level. In Europe as a whole, for example, it is still not clear what impact consolidation plans will have on activity levels in the coming years, given that sentiment levels have generally continued on an upward trend since measures were announced. Against this backdrop the risks surrounding the growth outlook - stabilisation in real GDP this year, followed by moderate output growth in the period 2011 to 2014 – appear to be broadly balanced. Upside risks to the outlook come primarily from the external side. In particular, the expectation that exports will increase by an average of less than 5% over the forecast horizon may turn out to be somewhat pessimistic, given that it is weaker than the historical relationship between exports and import growth in our main export markets would suggest. It is also possible that the clarity provided by this plan could result in a more rapid restoration of domestic confidence than is currently anticipated, while the structural reforms announced by the Government could see employment recover more rapidly. In general, however, domestic risks are tilted towards the downside. The most significant of these risks is that households maintain savings rates at current very high levels which would represent a continued constraint on personal consumption.

Comparison of Forecasts

Table A.2.1, below, compares the Department of Finance's 2011 forecasts for real GDP, real GNP, HICP inflation and employment growth with the latest published forecasts from a number of other institutions. The latest consensus forecast – a monthly publication by Reuters based on a survey of around 10 private sector institutions in Ireland – has also been included, to provide an indication of the private sector's view. In terms of economic growth, expectations for next year have generally been revised down since the start of 2010. While there is a divergence between the Department of Finance's growth outlook and that of the other institutions, this primarily reflects budgetary development. The forecasts are of a broadly similar vintage, but the Department's forecast is the only one that takes full account of the size of the consolidation that is now planned for next year. Nevertheless, even taking account of the need to do more in 2011, there remains a general consensus that the Irish economy will see a return to positive, but below trend, growth next year. In the case of inflation, prices are generally expected to begin to increase once again in 2011 following successive years of decline, while employment is forecast to stabilise over the course of next year.

Table A.2.1 Comparison of Macroeconomic Forecasts for Ireland in 2011

Institution	Publication	GDP	GNP	HICP	Employment
Department of Finance	National Recovery Plan	1 3/4	1.0	3/4	-1/4
ESRI	QEC, Autumn 2010	2 1/4	2	1/2	-0.5
Central Bank of Ireland	Bulletin, October 2010	2.4	1.7	1.1	-0.4
IMF	WEO, October 2010	2.3	n/a	0.5	0.7
Consensus	Reuters Poll, October 2010	2.0	1.7	1.6	n/a

Sensitivity Analysis

The economic forecasts underpinning the public finance projections in this Plan are based on a total consolidation figure of €15 billion over the 2011-2014 period. This is the size of adjustment considered necessary to deliver a General Government Deficit of below 3% of GDP by 2014. However, the Plan is not only about bringing order to the public finances by 2014, essential though that is. The Plan also sets out the Government's strategy for economic growth, for jobs and for structural economic reform. Implementing these strategies and these reforms will assist greatly in generating the economic growth that will help to put the public finances back on a sustainable trajectory.

In the event that economic growth was to be stronger over the 2011 – 2014 period than is currently forecast, it may be the case that the €15 billion adjustment would result in an improved deficit target. If, on the other hand, economic conditions were to weaken significantly, a consolidation of €15 billion would not be sufficient to achieve the stabilisation of the debt ratio over the period and achieve a deficit ratio of less than 3% of GDP by 2014.

To illustrate how the public finances would respond to a growth path different from the one assumed in the baseline, the ESRI's macro-econometric model (HERMES) was used to simulate a situation in which the level of output was 1% different throughout the forecast period due to (a) changes in interest rates or (b) changes in world demand. The model's estimates suggest that a 1 percentage point reduction in output would lead to deterioration in the General Government Balance (GGB) of about 0.3% to 0.6%, depending on the source (see Table A.2.2). This finding is broadly symmetrical, in that higher growth would improve the GGB by a similar amount. It is important to highlight that the estimates should be seen as indicative and are subject to considerable uncertainty. Also, it is assumed that there is no fiscal policy response to the changed budgetary position over the period. In reality such a response would occur if desirable in the interests of budgetary sustainability.

Table A.2.2 Impact on the Budget balance of a 1% change in level of output

	2011	2012	2013	2014
Baseline GDP Growth (%)	1.7	3.2	3.0	2.8
Baseline GGB (%)	-9.1	-7.0	-5.5	-2.8
<i>1 percentage point change in the level of output due to a change in interest rates</i>				
Cumulative impact on GGB (% GDP)	0.3	0.4	0.4	0.4
GGB range	-9.4 to -8.8	-7.4 to -6.6	-5.9 to -5.1	-3.2 to -2.4
<i>1 percentage point change in the level of output due to a change in world growth</i>				
Cumulative impact on GGB (% GDP)	0.6	0.6	0.6	0.6
GGB range	-9.7 to -8.5	-7.6 to -6.4	-6.1 to -4.9	-3.4 to -2.2

Annex 3

Debt-Deficit Dynamics

The key question as far as sustainability of the public finances is concerned is: when is the ratio of debt to GDP going to stabilise? When this point is reached depends on the relationship between four variables: the average interest rate on the debt, the growth rate of nominal GDP, the primary budget balance (the budget balance excluding interest payments), and the ratio of outstanding debt to GDP. When the interest rate exceeds the growth rate, a primary budget surplus is required to stabilise the debt ratio, with the size of that surplus dictated by (i) the size of the margin between the interest rate and growth rate and (ii) the size of the debt ratio. In the more benign circumstances of the growth rate exceeding the interest rate, stabilisation of the ratio is consistent with running a primary deficit below a certain limit, a limit determined by the interest rate – growth rate margin and the debt ratio.

Table A.3.1 sets out the forecast nominal GDP growth rate, the projected average interest rate on General Government Debt, the primary balance as a percentage of GDP and the end-year debt/GDP ratio for each of the years 2011 to 2014 that are consistent with this Plan. The conditions for stabilising the debt ratio are fulfilled in 2014. In that year, a substantial primary surplus is projected in circumstances where the average interest rate on the debt is only marginally higher than the rate of nominal GDP growth. As a result, the debt ratio is projected to fall.

Indeed, the trajectory of the debt ratio throughout the forecast period is somewhat lower than the relationship between these variables would suggest. The reason for this is that it is projected that Exchequer cash balances, which have been built up as a precautionary measure by the NTMA and are counted as part of the General Government debt, will be run down over this period. If for whatever reason, these cash balances were not used to help fund the budget deficit, the debt ratio would evolve as indicated in the final row of the table below.

Table A.3.1: Debt-Deficit Dynamics – The Baseline Scenario

	2011	2012	2013	2014
Nominal GDP growth (%)	2.5	4.2	4.3	4.6
Average interest rate (%)*	3.4	3.9	4.4	4.7
Primary budget balance (% of GDP)	-5.9	-3.2	-1.2	1.9
General government debt (end-year, % of GDP)	100	101	102	100
<i>General government debt (end-year, % of GDP)**</i>	<i>102</i>	<i>106</i>	<i>108</i>	<i>106</i>

* year t interest payments divided by end-year $t-1$ general government debt

** assuming that Exchequer cash balances are not used to fund the deficit

Obviously, if interest rates evolve in a different way from that assumed and/or the actual growth rate of nominal GDP is different from forecast, debt stabilisation will occur at a level and/or at a point in

time different from what is projected in the above table. Either higher than assumed interest rates on government debt or lower than forecast GDP growth would push up the trajectory of the debt-GDP ratio and would tend to delay stabilisation of the ratio, even assuming an unchanged profile for the primary budget balance. Moreover, either of these events would actually tend to worsen the primary budget balance. On the other hand, if interest rates turn out to be lower than assumed and/or GDP growth is higher, the debt ratio would follow a lower trajectory and would tend to start falling sooner than in the scenario envisaged in this Plan.

Table A.3.2: Debt-Deficit Dynamics - Sensitivity Analysis

	2011	2012	2013	2014
<u>Pessimistic Scenario*</u>				
Nominal GDP growth (%)	1.5	3.2	3.3	3.6
Average interest rate (%)	4.4	4.9	5.4	5.7
Primary budget balance (% of GDP)	-6.3	-4.0	-2.4	0.3
General government debt (end-year, % of GDP)	102	106	110	113
<i>General government debt (end-year, % of GDP)**</i>	<i>104</i>	<i>111</i>	<i>116</i>	<i>119</i>
<u>Optimistic Scenario*</u>				
Nominal GDP growth (%)	3.5	5.2	5.3	5.6
Average interest rate (%)	2.4	2.9	3.4	3.7
Primary budget balance (% of GDP)	-5.5	-2.4	0.0	3.5
General government debt (end-year, % of GDP)	97	96	94	89
<i>General government debt (end-year, % of GDP)**</i>	<i>100</i>	<i>101</i>	<i>100</i>	<i>95</i>

* see text for explanation

** assuming that Exchequer cash balances are not used to fund the deficit

Table A.3.2 explores the sensitivity of the trajectory of the debt-GDP ratio to variations in the interest rate assumptions and GDP forecasts. In the pessimistic case the average interest rate on the debt is raised by 1 percentage point and the annual GDP growth rate is lowered by 1 percentage point for each year of the 2011-2014 period. In this scenario, the conditions for stabilising the debt ratio are not met by 2014: the primary surplus achieved in that year is too small to offset the effect of the interest rate being significantly above the GDP growth rate.

In the optimistic scenario, where the interest rate trajectory is set 1% lower and the GDP growth rate 1% higher than in the base case, the conditions for stabilising the debt ratio are met in 2013. By that year, the primary deficit has been eliminated and in 2014 a large primary surplus is achieved, with the result that the debt ratio (helped also by the running down of Exchequer cash balances) falls significantly. Even on an underlying basis, the debt ratio is falling decisively by 2014 in this scenario.

In the baseline scenario, the average effective interest rate on the debt in 2011, calculated as projected interest payments in 2011 divided by end-2010 General Government Debt, is estimated at 3.4%. A key reason for this seemingly low figure has to do with the fact that, of the €149 billion stock of debt that will be outstanding at end-2010, almost €31 billion comprises the promissory notes issued by way of support to the banking system during the year. In 2011, the first funding of the promissory note programme, amounting to €3.1 billion, will take place and will generate interest payments of around €200 million on an annual basis.

Annex 4

Budgetary Data

Table A.4.1 Budgetary Projections 2010-2014

	2010	2011	2012	2013	2014
	€ bn	€ bn	€ bn	€ bn	€ bn
CURRENT BUDGET					
Expenditure					
Gross Voted Current Expenditure	54.8	52.8	50.9	49.4	48.0
Non-Voted (Central Fund) Expenditure	6.4	6.8	8.8	10.0	11.0
Gross Current Expenditure	61.2	59.7	59.7	59.4	59.1
less Expenditure Receipts and Balances	13.8	12.7	13.0	13.4	13.9
Net Current Expenditure	47.4	47.0	46.7	46.0	45.2
Receipts					
Tax Revenue	31.5	33.4	36.3	39.2	42.2
Non-Tax Revenue	2.7	2.0	1.1	0.9	0.9
Net Current Revenue	34.2	35.4	37.5	40.1	43.1
CURRENT BUDGET BALANCE	-13.2	-11.6	-9.2	-5.9	-2.1
CAPITAL BUDGET					
Expenditure					
Gross Voted Capital	6.1	4.7	4.3	3.9	3.5
Non-Voted Expenditure	1.4	4.5	4.2	4.0	3.9
Payment to the NPRF			0.4	1.4	1.4
less Capital Receipts	0.4	0.3	0.3	0.3	0.3
Net Capital Expenditure	7.1	8.8	8.6	9.0	8.5
Capital Resources	1.6	2.0	1.6	1.8	2.1
CAPITAL BUDGET BALANCE	-5.5	-6.9	-7.0	-7.2	-6.5
EXCHEQUER BALANCE	-18.8	-18.4	-16.2	-13.1	-8.5
GENERAL GOVERNMENT BALANCE	-49.9	-14.7	-11.7	-9.6	-5.0
<i>% of GDP</i>	<i>-31.7</i>	<i>-9.1</i>	<i>-7.0</i>	<i>-5.5</i>	<i>-2.8</i>
UNDERLYING GENERAL GOVERNMENT BALANCE	-18.5				
<i>% of GDP</i>		<i>-11.7</i>			

Rounding may impact on totals

Note: This Plan is based on the information available up to mid-November 2010. The figures referred to in the document may change as a result of policy decisions taken by Government after publication.

Annex 5

Macroeconomic and Budgetary Data Macroeconomic Prospects

Table A.5.1 Macroeconomic Prospects

	2010 % change	2011 % change	2012 % change	2013 % change	2014 % change
Real GNP	-2	1	2½	2½	2½
Nominal GNP	-4½	2	3½	4	4¼
Nominal GNP (<i>level</i>)	125,500	127,900	132,500	137,600	143,400
Real GDP	¼	1¾	3¼	3	2¾
Nominal GDP	-1½	2½	4¼	4½	4½
Nominal GDP (<i>level</i>)	157,300	161,200	168,100	175,400	183,500
Components of real GDP					
Private Consumption	-1¼	0	1	1½	1¾
Government Consumption	-4	-3	-2	-2¼	-2
Investment	-21¼	-6	5¼	5	5¼
Exports of goods and services	6¼	5	5	4½	4
Imports of goods and services	2¾	2¾	3	3¼	3
Contribution to real GDP growth					
Final domestic demand	-4¾	-1¼	¾	1	1¼
Changes in stocks	1½	¼	0	0	0
External trade balance	3½	2½	2½	2	1¾

Table A.5.2 Price developments

	2010	2011	2012	2013	2014
GDP Deflator	-1¾	¾	1	1¼	1½
HICP	-1½	¾	1	1¾	1¾

Table A.5.3 Labour market developments

	2009 %	2010 %	2011 %	2012 %	2013 %	2014 %
Employment, persons	1,929,000	-4	-¼	1¼	1½	1¾
Unemployment rate (%)	11¾	13½	13¼	12	11	9¾
Labour productivity, per employee (GNP) %	-2¾	2	1¼	1¼	¾	½

Annex 6

Performance Budgeting

'Performance Budgeting' is the term used to describe ways of strengthening the focus upon what is delivered with public funds, and factoring this into the resource-allocation process, in preference to the traditional approach of focusing narrowly on the financial inputs.

Ireland's system of resource allocation centres upon the traditional Vote accounting framework, whereby financial allocations are authorised by the Dáil and accounted for on a subhead-by-subhead basis. In recent years, this has been complemented with the *Annual Output Statement (AOS)* approach, which includes information on public service performance and outputs.

In its 2008 Review of the Irish Public Service, the OECD was broadly supportive of the AOS concept, and called for improvements to build performance information into the budgeting process. This approach has been taken up in the Government's *Transforming Public Services* agenda.

Proposed Approach

The Government has decided to integrate key, high-level performance information as part of the annual Estimate, rather than continue to present such information in two separate documents – the Estimate and the AOS – which are hard to reconcile with each other. This approach to 'performance budgeting' will involve:-

- full alignment between the subhead structure of the Estimate and the 'Programme' structure used in the AOS and Statement of Strategy;
- integration of Administration subheads alongside the corresponding Programme subheads, to show the full costs of delivering each Programme; and
- inclusion of concise, high-level performance and impact information as part of the annual Estimate.

The Government will progress this initiative by way of a pilot project, involving a policy-focused area (the Department of Finance and the wider Finance Group of Votes) along with an area focused on operation and service delivery (the Department of Agriculture, Fisheries & Food). The 2011 Estimates for these areas will be prepared on the new Programme Estimate basis, and the new approach will be rolled out to other Departments from 2012.

Annex 7

Multi-Annual Expenditure Framework

Multi-annual expenditure planning is already in place in a number of other countries, both in the EU and further afield; and this approach features strongly in the recent Commission Communications on Enhancing Economic Policy Coordination, and in the deliberations of the Van Rompuy Task Force.

The essence of this system is to set fixed expenditure ceilings for each of a multi-year cycle for each main area of expenditure, rather than just for one year as is currently the case. This would require public commitments to ongoing budgetary discipline, and a political commitment to observe the proposed limits (subject to the normal discretion of any new political administration to re-configure and to re-prioritise areas of expenditure, and the overall composition of fiscal policy, as it considers appropriate).

Based on the experience of other countries, and taking into account the background and preparatory work that has been undertaken within the Irish public service for some time, the Government proposes to introduce a Medium Term Expenditure Framework (MTEF) on the basis outlined below.

- (i) *Aggregate Expenditure Levels* – The starting point for an MTEF is a Government decision on an overall, 'top down' upper limit for aggregate Voted current spending for the multi-year period ahead, consistent with its broader medium-term budgetary plan. For the period 2011-2014, the Government's National Recovery Plan sets out the overall parameters in this regard.
- (ii) *Governmental Expenditure Assessment (GEA)* – A comprehensive review of all areas of Government spending should be conducted every 2-3 years to assess the relative contribution of each area towards meeting Government commitments, and to evaluate its relative priority in terms of resource allocation policy. For the purpose of this Plan, the Government has been in a position to draw upon the extensive analytical work undertaken by all Government Departments, and by the Department of Finance, over the course of 2009 and 2010. In future years, a separate GEA exercise would be undertaken periodically by the Department of Finance, and reflecting the priorities identified in any new or revised Programme for Government.
- (iii) *Ministerial Current Expenditure Envelopes* – Once the Aggregate Expenditure Levels are decided, and in light of the outcome of the GEA/review of expenditure priorities, the Government applies cash ceilings for current expenditure within each Ministerial Vote Group, so that programmes can be managed and prioritised within a fixed, determinate 'envelope' of spending over the multi-annual period.

- (iv) *Current Carryover provision:* As in the case of the existing Multi-annual Capital envelopes, the current envelopes will include provision for limited carryover of unspent moneys from one year to the next, to promote effective budgetary management and Value for Money (VFM) within Departments.
- (v) *Numbers Policy and Administrative Budget Agreements* – The other multi-annual expenditure management mechanisms currently in use – namely the Employment Control Frameworks (ECFs) for controlling staff numbers and the Administrative Budget Agreements (which apply to the civil service) – would be subsumed into the overall multi-annual framework set out above.

Implementation

The publication of this Plan represents a first decisive step in the implementation of the MTEF. Under the Plan, overall expenditure limits are specified for the period to 2014, with the establishment of Ministerial Current Expenditure Ceilings for the coming years.

The specific expenditure savings to be implemented in 2011 and later years are detailed in Chapter 4 of this Plan, with further details for each expenditure area in Annex 8.

During the course of 2011, and each subsequent year, a primary task of each Minister, and in turn of each Head of Department and Office, will be to refine and re-formulate the specific policy measures – including medium-term, structural measures – that will allow for the fixed expenditure ceilings to be adhered to over the years ahead.

On this basis, the specific expenditure reduction targets set out in this Plan, for each area of expenditure, will be delivered.

Annex 8

Detailed Information relating to Expenditure Measures

Chapter 4 of this Plan outlines the current expenditure savings required in the years to 2014 in order to put the public finances on a more stable footing, with a focus upon each of the broad categories of expenditure. This Annex sets out the savings to be secured in 2011 on the basis of a range of specific measures in each spending area, as well as the scale of further savings to be delivered from each area in the period 2012-2014. Further details for Social Protection and the Book of Estimates will be published on Budget day, December 7th.

Table A.8.1 below shows the overall current expenditure position for each Departmental spending area. The table shows that the range of measures to be introduced in 2011 will deliver full-year structural savings amounting to about €2.7 billion. This front-loading of the expenditure adjustment means that a balance of just under €4.3 billion must be secured over the remaining three years of the consolidation period, to deliver overall current expenditure savings amounting to €7 billion by 2014.

Table A.8.1 Savings to be achieved in 2011 and remaining savings in the period to 2014				
	2011 Measures* (First Year, €m)	2011 Measures* (Full Year, €m)	Further Measures (by 2014, €m)	Total (€m)
Agriculture, Fisheries & Food	75	101	120	221
Communications, Energy & Natural Resources	8	12	8	20
Community, Equality & Gaeltacht Affairs	19	27	8	35
Defence	28	46	60	106
Education & Skills	182	312	379	690
Enterprise, Trade & Innovation	14	37	10	47
Environment, Heritage & Local Government [^]	84	91	220	311
Finance	32	60	25	85
Foreign Affairs, including ODA	42	37	150	187
Health & Children	746	765	680	1,445
Justice & Law Reform	74	230	140	370
Social Protection	861	915	1,910	2,825
Taoiseach	8	11	24	35
Tourism, Culture & Sport	17	26	50	76
Transport	32	39	100	139
Other measures [^]	0	0	400	400
Total:-	2,221	2,709	4,283	6,992

*Includes Net Public Service pay and administrative savings. It excludes the effects of adjustments to Public Service pension levels. In 2011, these changes are expected to cost about €130 million, however by 2014 it is estimated that they will yield savings of some €8 million.

[^]These savings are contingent on enactment and implementation of legislation to raise revenues from water charges and the planned Local Service Contribution to finance local services.

Rounding may impact on totals.

The following sections provide further detailed information in relation to each of these spending areas, other than Social Protection, for which the relevant details are set out in Chapter 4.

Agriculture, Fisheries & Food

The Agriculture sector will contribute savings of €221 million by 2014. The specific savings targets for implementation in 2011 are set out in the table below.

	Yield 2011, €m	Yield Full year €m
<u>Agriculture</u>		
The key adjustments include programme savings, payroll savings and other running cost savings as set out below:		
Programme		
▪ Reduced expenditure on REPS	35.7	35.7
▪ Reductions in the Disease Eradication area due to reduced instances of disease in 2010	6.3	6.3
▪ Reduced expenditure on ERS due to scheme closure	5	5
▪ Reduction in Intervention costs	4.5	4.5
▪ Efficiencies in the running costs of State Bodies	3	3
▪ Other savings (including some running cost reductions)	5.5	5.5
▪ Payroll savings	6	26
Other		
▪ Non pay administrative savings	9	15.1
Total Agriculture Savings	75	101

Agriculture, Fisheries & Food 2012-2014

Achieving the targeted savings will require the adoption of further measures yielding some €120 million in the years to 2014. Consolidation will need to focus on streamlining a range of programmes. Options to be considered include prioritisation of financial support in schemes to active farmers, also taking into account CAP reform.

An alternative funding model to support the horse and greyhound industries will be introduced.

Communications, Energy & Natural Resources

The CENR area will contribute savings of €20 million by 2014. Specific measures for implementation in 2011 are outlined in the table below.

	Yield 2011, €m	Yield Full Year, €m
<u>Communications, Energy and Natural Resources</u>		
The key adjustments include a reduction in funding for TG4, payroll savings and non-pay savings as set out below:		
▪ Exchequer funding for TG4 will be reduced with the shortfall made up from RTE licence fee income yielding a net programme saving of €6.2m on the Vote	6.2	6.2
▪ Payroll savings	0	3
▪ Non-pay Administrative Savings	1.7	2.8
Total CENR Savings	8	12

Communications, Energy and Natural Resources 2012-2014

Achieving the targeted savings will require the adoption of further measures in the years to 2014 to save an additional €8 million. Further consolidation will need to focus upon rationalising and scaling-back of certain activities funded from this area.

Community, Equality & Gaeltacht Affairs

The CEGA area will contribute savings of €35 million by 2014. The expenditure savings proposed for implementation in 2011 are outlined in the table below.

	Yield 2011, €m	Yield Full year, €m
<u>Community, Equality & Gaeltacht Affairs</u>		
The key adjustments include reduced programme allocations particularly in community schemes, payroll savings and efficiencies in administrative non pay costs.		
Developing Communities		
• Reduced allocations across community development programmes / projects	8.7	8.7
• Adjustments in supports for the community & voluntary sector and volunteering		
Other programmes		
Tackling Problem Drug Use		
• Savings across community based drugs projects	0.4	0.4
Rural Development		
• Reduced funding for rural recreation	0.6	0.6
Gaeltacht & Island Development		
• Reduced funding for Gaeltacht schemes / services	1.4	1.4
Promotion and Maintenance of the Irish Language		
• Savings across Irish language support programmes.	0.6	0.6
Equality		
• Reduction in funding for equality and integration projects	0.9	0.9
Disability		
• Reduction in funding for disability projects	0.6	0.6
Other Services		
• Reductions in other programmes and administration.	1.8	1.8
Other		
▪ Payroll savings	1	6
▪ Non-pay administrative savings	3.1	5.5
Total CEGA savings	19	27

Community, Equality & Gaeltacht Affairs 2012 – 2014

Over the period to 2014, the full range of grant assistance programmes will have to be reviewed for further efficiencies and consolidation to secure an additional €8 million in savings.

Defence

The Defence area will contribute savings of €106 million by 2014. The savings targets and specific measures for implementation in 2011 are outlined in the table below

	Yield 2011, €m	Yield Full year , €m
Defence The key adjustments include reduced allowances for overseas deployment, payroll savings and efficiencies in administrative non pay costs.		
▪ Reduction in the provision for allowances for overseas deployment by the Defence Forces. Reduction in the number of civilian employees attached to military installations. Acquisition of replacement equipment, building and maintenance projects will be deferred or cancelled.	25	25
▪ Payroll savings	2.5	20
▪ Non-pay Administrative Savings	0.1	0.4
Total Defence Savings	28	46

Defence 2012 – 2014

Achieving the further targeted ongoing savings of €60 million by 2014 will require the adoption of a number of measures additional to those outlined above. This will involve a critical appraisal of every area of activity within the Defence Forces, including overseas duties and domestic services, with a view to maximising efficiency in every area, including procurement. Should it prove difficult to achieve the savings at the targeted personnel level, it may become necessary to consider further personnel reductions.

Education & Skills

The table below outlines the measures to be adopted in 2011 to achieve the saving required. These structural measures have a significantly higher medium-term impact, thus lessening the need for further policy savings from this sector in future years. Structural changes early in the adjustment process can yield substantial future savings, particularly in the area of pupil staffing ratios. Allocations from the National Training Fund will also be reduced and the impact on training and employment supports will have to be managed within the reduced allocation. The Government will continue to place an emphasis on providing training for the unemployed, in particular those cohorts that are in danger of becoming distanced from the labour market. The Education & Skills area, including FÁS, will contribute savings of €690 million by 2014.

	Yield 2011, €m	Yield Full year , €m
<u>Education and Skills</u>		
The key adjustments in the education sector include some one off measures as well as structural measures with significant medium-term impacts. The key adjustments are:		
School Transport		
▪ Operational efficiencies and other savings measures in the school transport scheme	4.5	17
School Funding:		
▪ 5% Reduction in all capitation grants, including grants for Adult Literacy, Community Education, School Completion Programme, Youthreach.	22.2	22.2
Education Fees:		
▪ Replace Student Services Charge with a flat higher education student contribution of €2,000, and introduce €200 charge for PLC students.	31	31
Student Support:		
▪ Savings in the student support scheme	22	51
Third Level:		
▪ 5% cut in non-pay grant to Universities/IOTs etc.	14	14
NEPS:		
▪ Cap numbers at current level of 178	3	3
FAS/Training Allowances & similar Support Payments		
▪ Savings measures	21	21
Payroll savings		
▪ Reduce teacher numbers by a combination of measures	24	97.6

▪ Supervision and substitution: 3 rd class period under Croke Park Agreement & tighten measures in rules for scheme	10	10
▪ 10% reduction in salary for new entrants and all entrants to start on 1 st point	1	12
▪ Additional reductions in PS numbers	11	19
Other		
▪ Non-pay Administrative Savings	4	9.1
▪ Management of emerging expenditure pressures and other estimated savings	14	5
Total Current Savings:-	182	312

Education 2012 – 2014

The Government's prioritisation of education investment to date and over the period of the Plan is clear with more favourable treatment of teacher and Special Needs Assistants (SNA) posts under public sector numbers policy and the moratorium on filling vacancies. However, it is essential that a significant reduction is achieved in teacher payroll (including substitution) costs over the period of the plan through more efficient deployment of existing teacher numbers, reduction in teacher numbers and/or other productivity, efficiency and pay-related measures that deliver reductions in payroll (including substitution) costs.

The Plan provides for a further reduction in teacher payroll costs, from the school year 2012/13. In advance, the Department of Education and Skills will consult with the education partners and provide them with an opportunity to contribute to the process of identifying a range of measures that Government can consider. If alternative feasible measures to deliver these savings cannot be identified, appropriate increases in the classroom teacher allocation schedule will be introduced.

There have been significant increases in the number of SNAs in recent years. In that regard, while no reduction in SNA numbers is proposed over the period of the plan, it is intended to cap SNA numbers at the 2011 level and introduce a new system to facilitate the management of these finite SNA resources in a proactive manner.

The issue of a higher student contribution to the cost of higher education is discussed in Chapter 4.

Enterprise, Trade & Innovation (ET&I)

The Government sees the ET&I area in particular as a driver of the innovative, smart economy that will lay the basis for sustainable growth and employment creation into the future, as detailed in Chapters 1 and 2 of this Plan. In securing balanced savings from the ET&I area, there will accordingly be a need to preserve and to promote those areas of activity that feed into the Government's overall growth strategy. The Enterprise area will contribute €47 million of savings by 2014. Specific measures for implementation in 2011 are outlined in the table below.

	Yield 2011, €m	Yield Full year, €m
<u>Enterprise, Trade and Innovation</u>		
Savings will be secured across the range of programme activities and supports provided in the ET&I area as follows:		
Programme		
▪ Administrative Budget (including NERA and the ODCE)	0.7	0.7
▪ Industrial Relations/Social Partnership	0.8	0.8
▪ Rationalising expenditure on Consumer Affairs	0.5	0.5
▪ Targeting of funding for Science, Technology & Innovation	2.4	2.4
▪ Curtailment of allocations for Enterprise Agencies through operational efficiencies	0.8	0.8
▪ Realignment of funding for the Health & Safety Authority	0.5	0.5
▪ Miscellaneous	0.3	0.3
Other		
▪ Payroll savings	4	23
▪ Non pay administrative savings	4.5	8.2
Total ET&I Savings	14	37

Enterprise, Trade & Innovation 2012 – 2014

Achieving the further targeted ongoing savings of €10 million by 2014 will require the adoption of further efficiencies and programme adjustments. Given the strategic priority of this area, the additional savings contribution over the period 2012-2014 will be kept to a minimum amount.

Environment, Heritage & Local Government (EHLG)

Savings of up to €311 million are proposed to be implemented by 2014 from the EHLG area (which includes Exchequer support for the Local Authorities). Specific measures for implementation in 2011 are outlined in the table below.

	Yield 2011, €m	Yield Full year, €m
<u>Environment, Housing & Local Government</u>		
There will be reductions within the housing, local government, heritage and community areas. In addition payroll and administrative savings are targeted. The key adjustments include the following:		
Programme		
▪ Lower Exchequer contribution to the Local Government Fund. Off-setting measures in the local government sector will be introduced	62	62
▪ Savings will also arise from efficiencies in		
- Environmental protection measures	9	9
- Built and Natural Heritage Programmes	7	7
- Scheme of support to Voluntary and Community Fora	1.2	1.2
▪ Use Cash Reserves in Agencies (RPII & Heritage Council)	0.75	-
Other		
▪ Payroll savings	1	7
▪ Non-pay administrative savings	2.6	4.2
Total EHLG Savings:-	84	91

Environment, Heritage & Local Government 2012 – 2014

Savings and offsetting measures within the local government sector in 2012-2014 will allow the Exchequer to end its contribution to the Local Government Fund. The introduction of water charges and the local charge as proposed by the Government will lead to significant additional revenues from 2014.

Finance Group of Votes

The Finance Group includes the Revenue Commissioners and the Office of Public Works as well as the Department of Finance. Savings of €85 million will be implemented by 2014. The savings measures for 2011 are set out in the table below.

	Yield 2011, €m	Yield Full year, €m
Finance		
The key adjustments include programme savings, payroll and administrative savings		
▪ A range of measures predominantly in the OPW, Revenue and Finance areas	26	26
▪ Payroll savings	5	28
▪ Non pay administrative savings	0.8	6
Total Finance Savings:-	32	60

Finance Group of Votes 2012 – 2014

Achieving these savings targets will require the adoption of further measures in the years to 2014 including:

- Economies and efficiencies on all Votes;
- Rationalisation of Departmental accommodation needs;
- Reduction on maintenance spending and spending on visitor centres;
- Efficiencies in tax collection through structural reform of the taxation system

Taken together, these measures should contribute towards additional savings of €25 million by 2014.

Foreign Affairs, including ODA

Savings of up to €187 million will be implemented from the Foreign Affairs area by 2014. Specific measures for implementation in 2011 are outlined in the table below.

	Yield 2011, €m	Yield Full year, €m
Foreign affairs The key adjustments include programme savings, payroll and administrative savings		
Programme savings <ul style="list-style-type: none">▪ Curtailment of the allocation for Overseas Development Assistance (ODA)▪ Introduction of passport fees for over 65s▪ Rationalisation of the allocation for Overseas missions▪ Other programme savings	35 2.3 0.5 0.5	35 2.3 0.5 0.5
Other <ul style="list-style-type: none">▪ Payroll savings▪ Non-pay administrative savings	1.0 3.0	1 -2.5
Total Foreign Affairs Savings	42	37

Foreign Affairs 2012 – 2014

Achieving additional ongoing savings of the order of €150 million by 2014, in addition to the savings outlined in the table above, will require a reduction in ODA to more affordable levels consistent with international targets. Further efficiencies and economies in the diplomatic service will be made.

Health and Children

The table below outlines the measures to be adopted in 2011 to achieve the €746 million saving required in the Health area.

	Yield 2011 €m	Yield Full year, €m
<u>Health and Children</u>		
The following are the key adjustments in the Health and Children area:		
Programme		
<ul style="list-style-type: none"> ▪ Vote 39 and its agencies (including savings in Admin Budget and allocations to Health agencies) and Vote 41 childcare and youth scheme savings ▪ Procurement and Demand Led Schemes savings 	36 444	36 454
Other		
<ul style="list-style-type: none"> ▪ Payroll savings from proposed numbers reduction in the HSE, including the VER/Severance Package, and other savings and efficiencies in non-core pay costs ▪ Non-pay Administrative Savings:- 	259 7.5	257 18.4
Total H&C Savings:-	746	765

Health 2012 – 2014

As the above table shows, additional savings of €680 million will need to be implemented in the Health area by 2014. The main focus will be on protecting essential healthcare services, and continuing to achieve efficiencies in pay and non-pay costs, including through changes in the way services are delivered (e.g. by making increasing use of the day-care procedures and reducing average lengths of stay and better bed management). Other measures that will be implemented over this period include:

- Cost savings in community schemes through measures which also achieve greater graduation of supports across those on different income levels, remove poverty traps/employment disincentives and better support health policy objectives;
- Building upon the success of the Fair Deal Scheme, the introduction of an approach to community support for older people which takes need and financial means into account on a nationally consistent basis;
- Changes in the existing range of dental services and supports provided through the healthcare and social protection systems in order to improve access to essential dental services for those most in need;
- Further increases in the charges for private/semi-private treatment in public hospitals to achieve full cost recovery; and

- The introduction of clinical guidelines to improve prescribing behaviours in order to generate savings in drug costs, where appropriate, and reduce other treatment costs by providing more effective drug treatment.

Justice & Law Reform

The Justice sector includes the Garda Síochána, the Prisons and Courts Services, as well as the Department of Justice & Law Reform. This area will contribute savings of €370 million by 2014. Specific measures for implementation in 2011 are outlined in the table below.

As this area of expenditure is staff-intensive, savings will be made through progressive scaling back in existing numbers levels, with associated administrative efficiencies. Structural reform and numbers reduction measures from 2011 deliver a progressively higher full-year impact out to 2014.

	Yield 2011, €m	Yield Full year, €m
<u>Justice</u> The range of schemes and programmes in the Justice sector will be adjusted on the basis set out below:		
Vote 19 <ul style="list-style-type: none">▪ Criminal Legal Aid – fees and structure changes▪ Asylum savings on accommodation & other costs▪ Probation Service – better targeting of resources▪ INIS – savings on foot of lower numbers of asylum seekers etc	5 5 5 -	10 10 10 30
Vote 20 <ul style="list-style-type: none">▪ Garda Management Efficiencies	20	25
Vote 22 <ul style="list-style-type: none">▪ Courts –efficiencies across network of Courts▪ Procurement Savings	5 10	15 20
All votes <ul style="list-style-type: none">▪ Payroll savings▪ Non-pay administrative savings:-	18 5.6	100 10.1
Total Justice Savings:-	74	230

Justice 2012-2014

Achieving these savings targets will require the adoption of further measures in order to generate savings of €140 million. These will include:

- Reductions in overtime, allowances and travel costs;
- Reductions in transport spending;
- Further economies in the cost of Civil & Criminal Legal Aid, INIS, Asylum Accommodation and Probation Service; and
- Efficiencies and economies across the whole Vote Group.

Taoiseach's Group of Votes

The Taoiseach's Vote Group comprises the Votes of the Department of the Taoiseach, the Central Statistics Office (CSO) and the Law Offices (i.e. Office of the Attorney General and Office of the Chief State Solicitor). Savings of up to €35 million will be implemented from the Taoiseach's Group of Votes by 2014. The table below sets out the specific measures for implementation in 2011.

	Yield 2011, €m	Yield Full year €m
Taoiseach's Group of Votes The focus of savings in the Taoiseach's Group of votes is primarily aimed at administrative efficiencies given that most of the expenditure across this group of votes comprises administrative budgets.		
Department of the Taoiseach <ul style="list-style-type: none"> ▪ Reduction in the administrative budget ▪ Programme Savings 	1.0 1.4	1.0 1.4
Office of the Attorney General <ul style="list-style-type: none"> ▪ Rationalisation of administration expenditure 	0.1	0.1
CSO <ul style="list-style-type: none"> ▪ Curtailment of administrative costs (€2 million of the savings in 2011 are once-off and arise in Census 2011 and Household Budget Survey) 	3.0	1.0
Other <ul style="list-style-type: none"> ▪ Payroll savings across all votes ▪ Non-pay administrative saving 	1 2.0	4 3.6
Total Taoiseach's Group Savings:-	8	11

Taoiseach's Group 2012 – 2014

The 2011 savings will be intensified in the period 2012–2014 through the continuation of administrative and operational efficiencies and the increased prioritisation of work programmes to meet emerging demands placed on the Department of the Taoiseach, the Legal Offices and CSO. The outputs of the Law Offices, in particular, are demand-driven and the Offices, in addition to securing economies and increased operational efficiencies, have been exerting strong control on expenditure on legal fees. This will be continued over the coming years. The outputs of the CSO are similarly demand-driven to a large degree and respond to European Union and national statistical obligations. The CSO has also achieved operational savings and continues to prioritise work programmes in light of emerging budgets. The 2011 allocation for the CSO includes significant additional resources to provide for conducting the 2011 Census of Population. These resources will be reduced in 2012 and in subsequent years.

Tourism, Culture & Sport

The Tourism, Culture & Sport area will contribute savings of €76 million by 2014. The specific measures for implementation in 2011 are outlined in the table below.

	Yield 2011, €m	Yield Full year, €m
<u>Tourism, Culture & Sport</u>		
The savings measures for this area comprise programme savings across the arts, culture and sport sectors as well as payroll and administrative savings. The key adjustments are set out below:		
Programme savings		
▪ Reduction in tourism expenditure through operational efficiencies, prioritisation of activities and more focused tourism marketing investment	5	5
▪ Reduced funding for sporting bodies and agencies including Irish Sports Council and National Sports Campus	3	3
▪ Reduced allocations to cultural institutions and cultural projects	5	5
Other		
▪ Payroll savings	0	6
▪ Non-pay administrative savings	4.0	7.2
Total Tourism, Culture & Sport Savings:-	17	26

Tourism, Culture & Sport 2012 – 2014

Additional savings amounting to €50 million will be required post 2011 involving:

- reductions in the allocations to sporting bodies and grants to local sports organisations;
- reduction in allocation to the Arts Council and other Cultural activities; and
- better focusing and prioritisation of Tourism spending.

Transport

Savings of up to €139 million will be implemented from the Transport Vote by 2014. Specific measures for implementation in 2011 are outlined in the table below.

	Yield 2011, €m	Yield Full year, €m
<u>Transport</u>		
The adjustments in the Transport area comprise a variety of programme measures as well as payroll and non-pay savings. The following are the key adjustments for the Transport area:		
Administration		
▪ Achievement of administrative savings	0.18	0.18
Roads		
▪ Across the board reduction in maintenance expenditure on national, regional and local roads.	9	9
▪ Reduction of the Exchequer grant to the Road Safety Authority. Where operational efficiency savings fall short of meeting this reduction, the authority can seek to raise service fees up toward a level that represents full cost-recovery.	5	5
▪ Operational efficiency savings arising from increased use of online motor tax service – reduced postal costs and bank clearing charges.	0.5	0.5
Public Transport		
▪ Reduction in subvention to public transport companies, agency rationalisation and administrative savings.	10	10
Aviation		
▪ Regional Airports – Curtailment of support for regional air services from mid-2011.	5.5	5.5
Other		
▪ Payroll savings	0	5
▪ Non-pay Administrative Savings	2.1	3.3
Total Transport Savings	32	39

Transport 2012 – 2014

The breakdown of the additional savings target of €100 million by 2014 for the Department of Transport includes:

- Further reductions in road maintenance expenditure;
- Further reduction in the administrative provision for agencies generally and through post-merger administrative provisions for the National Road Authority and the Railway Procurement Agency, arising from normal overhead consolidation – staff, back office support, administration, office space etc;

- Future funding requirements for agencies should be increasingly met from a raising of fees towards full cost recovery levels; and
- Further rationalisation of services through implementation of the Deloitte Report will mean reduced levels of subvention in future years.

Revised Gross Current Ceilings

Taking account of all of the measures outlined above, Table A.8.2 below sets out the new expenditure ceilings that will apply for each Vote Group in the years to 2014. These are the pre-Budget Estimates adjusted for the savings set out in Table A.8.1.

Table A.8.2 Current Expenditure Ceilings by Vote Group, 2011 – 2014				
	2011 €m	2012 €m	2013 €m	2014 €m
Agriculture, Fisheries & Food	1,346	1,136	1,057	1,029
Communications, Energy & Natural Resources	337	333	330	325
Community, Equality & Gaeltacht Affairs	265	258	254	250
Defence	925	891	869	841
Education & Skills	9,200	9,020	8,950	8,875
Enterprise, Trade & Innovation	392	369	355	344
Environment, Heritage & Local Government*	599	555	492	370
Finance	1,265	1,257	1,203	1,189
Foreign Affairs, including ODA	728	721	725	712
Health & Children	14,094	13,848	13,736	13,674
Justice & Law Reform	2,321	2,125	2,009	1,960
Social Protection	20,152	19,338	18,494	17,901
Taoiseach	201	162	155	141
Tourism, Culture & Sport	296	274	256	234
Transport	681	634	602	560
Unallocated Adjustment	20	-10	-80	-380
Total:-	52,823	50,910	49,408	48,024

*These Environment, Heritage & Local Government provisions are contingent on enactment and implementation of legislation to raise revenues from water charges and the planned Local Service Contribution to finance local services

Annex 9

eGovernment and ICT

eGovernment

- Since 2008, the Government has ensured a renewed focus on achieving progress with eGovernment. This has resulted in the development of a comprehensive eGovernment Strategy, detailed eGovernment plans in individual civil and public service bodies, and a Rolling Programme of priority eGovernment projects. The current Rolling Programme contains 20 key projects. This will change over time as projects are completed and new ones come on-stream.
- The current eGovernment Strategy focuses on enhanced delivery of information electronically, enhanced electronic delivery of services, and enhanced use of shared technology approaches. It recommends ways of overcoming some of the difficulties and barriers there are with putting certain information and services online. The eGovernment plans of individual bodies are being developed in accordance with these recommendations.
- As a consequence, most public bodies now publish comprehensive information on their services and schemes online, a wide range of public services are now either fully or partially available online, and many public bodies are now using shared technology approaches to deliver these. The result of this renewed focus is evidenced by Ireland's improvement from 17th to joint 7th in the last EU Commission e-Government Benchmark and by the hundreds of facilities now available online from the Public Service. Additionally, Ireland is now considered to be one of the best performers in eProcurement by the EU Commission.
- The Department of Finance is responsible for overseeing and co-ordinating this effort and reports regularly to the Cabinet Committee on Transforming Public Service on the rate of progress being achieved to ensure that the focus is maintained at the highest levels.
- The following activities are now underway/being planned:
 - Preparations are being made to publicise the extent of online information and services, to ensure that people and businesses are more aware of what is available and to encourage greater uptake of the online channels;
 - The Department of Finance and the Citizens Information Board (CIB) are developing a single Government portal providing access to information on public services, online access to these services, and detailed location and contact information on public bodies. The intention is to launch the new portal early in the New Year;
 - The Department of Finance has developed a central system to provide a single view of the identity of Public Service customers (known as the Single Customer View), and has successfully piloted it and a range of associated applications with public bodies. This solution will be instrumental in helping public bodies to improve the quality of customer identity data, improve assurances around identity claims, remove duplication of effort

from recording and checking processes, and facilitate the provision of online identity services. The Department is now working on the legal basis necessary to put this solution into production with the intention of doing that during the course of 2011;

- Further phases of the eGovernment Strategy are being considered:
 - online channels become most effective and give the most opportunity for driving efficiencies and cost-savings when utilised extensively. A range of mechanisms, including administrative and legal ones, will be explored to enhance the uptake of electronic services and self-service;
 - while there is already a great deal of back-end integration between the systems and processes of public bodies, there is scope for doing more. Mechanisms for doing this will be explored and advised on;
 - a number of public bodies already publish some of their datasets online. The potential for doing this more generally is being explored both within the Public Service and with academic and private sector organisations. This exploration will seek to identify how such publishing can be done in a way that provides value to the general public and facilitates the development of both free and commercial products;
 - a number of public bodies have already used online collaboration facilities with varying degrees of success. The lessons from these early adopters are being examined to determine how best to exploit collaborative technologies to give citizens and businesses more insight on developments as they occur, greater involvement in policy deliberations where applicable, and greater access to mechanisms for giving their views; and
 - a comprehensive Identity Management Policy for the public service is being developed. This is necessary given the dependence on many schemes and services on proper identification of customers, the need to facilitate greater personalisation in the delivery of services, and the need to comply with international legislation and obligations. Once the research and consultations are completed, a proposal will be submitted to Government for consideration. It is intended to do this during the course of 2011.

Central ICT Arrangements

- The Department of Finance has taken the lead in implementing a range of shared ICT approaches for the Public Service. These include:
 - Government Networks which provides all public bodies with a high-capacity, secure and resilient central Government Network to facilitate easy interconnectivity between them, protected access to the Internet, direct access to shared central services and applications, and interconnectivity with a wide range of voice and data service providers;
 - A nationwide secure digital radio communications infrastructure for all of the emergency and security services of the State; and

- A range of ICT procurement frameworks covering PCs, laptops, printers, mobile voice and data services, fixed voice and data services. These frameworks have resulted in savings of 35%-50% in costs to public bodies.
- The use of these procurement approaches has now been mandated on all public bodies to ensure that the maximum savings possible are garnered over the lifetime of this Plan.
- Other ICT procurement opportunities, especially in the areas of software licensing and support, are being examined to determine if similar approaches can be employed.
- The Department of Finance is working with other public bodies and a range of private companies to determine an appropriate approach for Government 'Cloud Computing'. A number of pilots are being planned. Although it will take a number of years to test and deploy models and facilitate migrations, Government Cloud Computing has the potential to facilitate considerable efficiencies and cost savings through reduced duplication and resource utilisation.

Annex 10

Taxation Measures

Table A.10.1 Taxation Measures: Plan Yield from measures taken in the years 2011–14 (€million)

	2011	2012	2013	2014 ³⁸	Total
Income Tax	1,245	260	210	160	1,875
Pensions	260	225	225	155	865
Tax Expenditures	405	100	100	60	665
Site Value Tax	-	180	175	175	530
Carbon Tax	-	220	-	80	300
Capital Tax	-	145	-	-	145
Value Added Tax			310	260	570
Other Measures	110	-	-	-	110
TOTAL:	2,020	1,130	1,020	890	5,060

- The figures in Table A.10.1 set out the total revenue raised as part of the Plan during the correction period to end 2014.
- This amounts to a cumulative revenue adjustment of €5.06 billion between 2011 and 2014.
- Additional revenue of just under €300 million will be carried over into the years after 2014 and will be fully realised by 2017.
- The full year impacts of all measures are set out in Table A.10.2 and the timing of the revenue flows are set out in Table A.10.3.

Table A.10.2 Taxation Measures: Yield by Budget Year and Full Year

	First Year	Full Year
Budget 2011	€1,400 million	€2,020 million
Budget 2012	€880 million	€1,130 million
Budget 2013	€810 million	€1,020 million
Budget 2014	€890 million	€1,185 million ³⁹

³⁸ Additional revenue of just under €300 million will be carried over into the years after 2014 and will be fully realised by 2017.

³⁹ See previous footnote.

Table A.10.3 Taxation Measures: Detailed breakdown, source and timing (€million)

	2011	2012 (c/f)	2013 (c/f)	2014 (c/f)	PLAN TOTAL	(c/f) 2015/17	Full Year
1. INCOME TAX							
<i>Increases equivalent to:</i>							
-10% bands & credits etc.	+945	(+300)			1,245		1,245
-2½% bands & credits		+200	(+60)		260		260
-2% bands & credits			+160	(+50)	210		210
-2% bands & credits				+160	160	(+50)	210
(Sub-Total)					(1,875)		(1,925)
2. PENSIONS⁴⁰							
-PRSI/HL relief etc.	+155	(+105)			260		260
-7% Pension Relief		+155	(+70)		225		225
-7% Pension Relief			+155	(+70)	225		225
-7% Pension Relief				+155	155	(+75)	230
(Sub-Total)					(865)		(940)
3. EXPENDITURES							
Income tax expenditures	+160	(+145)			305	(+50)	355
Property Incentives 'Tail'	+60	(+40)			100		100
Property Incentives 'Tail'		+60	(+40)		100		100
Property Incentives 'Tail'			+60	(+40)	100		100
Property Incentives 'Tail'				+60	60	(+40)	100
(Sub-Total)					(665)		(755)
4. LOCAL FINANCING							
Site Value Tax		+180			180		180
Site Value Tax			+175		175		175
Site Value Tax				+175	175		175
(Sub-Total)					(530)		(530)
5. CARBON							
+€10 Carbon Tax (€25)		+160	(+60)		220		220
+€5 Carbon Tax (€30)				+80	80	(+30)	110
(Sub-Total)					(300)		(330)
6. CAPITAL							
CGT and CAT Reform		+125	(+20)		145		145
(Sub-Total)					(145)		(145)
7. VAT							
o Standard Rate +1%			+260	(+50)	310		310
o Standard Rate +1%				+260	260	(+50)	310
(Sub-Total)					(570)		(620)
8. Other Tax Measures		+80	(+30)		110		
(Sub-Total)					(110)		(110)
TOTAL	1,400	1,500	1,060	1,100	5,060	295	5,355

⁴⁰ Includes impact on 'pensions related deduction' of a cumulative €240 million.

Annex 11

List of main abbreviations in this Plan

BES	Business Expansion Scheme
BIK	Benefit-in-Kind
BITES	Business Investments Targeting Employment Scheme
BOP	Balance of Payments
CAT	Capital Acquisitions Tax
CEGA	Community, Equality and Gaeltacht Affairs
CEO	Chief Executive Officer
CER	Commission for Energy Regulation
CGT	Capital Gains Tax
CIB	Citizens Information Board
CIP	Capital Investment Programme
CRO	Companies Registrations Office
CSO	Central Statistics Office
DETI	Department of Enterprise, Trade and Innovation
EBS	Educational Building Society
EI	Enterprise Ireland
ERO	Employment Regulation Order
ESB	Electricity Supply Board
ESRI	Economic and Social Research Institute
FÁS	Foras Áiseanna Saothair
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GMS	General Medical Services
GNP	Gross National Product
HICP	Harmonised Index of Consumer Prices
HR	Human Resources
HSE	Health Service Executive
ICT	Information and Communication Technology
IDA	Industrial Development Authority
IFSC	International Financial Services Centre
IMF	International Monetary Fund
INBS	Irish Nationwide Building Society
IP	Intellectual Property
MAN	Metropolitan Area Networks
MNC	Multi-National Companies
MIU	Major Inter-Urban Routes
NAMA	National Asset Management Agency
NCC	National Competitiveness Council
NCSA	Non-Commercial State Agencies
NCSSB	Non-Commercial State Sponsored Bodies
NMW	National Minimum Wage
NPF	National Pensions Framework
NPRF	National Pensions Reserve Fund
NPS	National Procurement Service
NTMA	National Treasury Management Agency
ODCE	Office of the Director of Corporate Enforcement
OECD	Organisation for Economic Co-operation and Development
OPW	Office of Public Works
PAYE	Pay-As-You-Earn

PIAB	Personal Injuries Assessment Board
PIK	Payment in Kind
PLC	Post Leaving Certificate
PRSI	Pay Related Social Insurance
R&D	Research and Development
REA	Registered Employment Agreement
SFI	Science Foundation Ireland
SFT	Standard Fund Threshold
SME	Small and Medium Enterprises
SPU	Stability Programme Update
STI	Science, Technology and Innovation
VAT	Value Added Tax
VEC	Vocational Education Committee
VFM	Value for Money
VTOS	Vocational Training Opportunities Scheme

Draft Preliminary Analysis



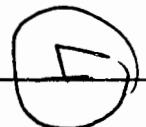
Presentation to

National Treasury Management Agency

26 September, 2008



Global Markets & Investment Banking Group



Draft Preliminary Analysis

Strategic Options

Observations

- Merrill Lynch has been engaged with the NMRA and the Department of Finance for 48 hours
- Analysis is based on the information from and conversations with:
 - PwC regarding Anglo
 - Goldman Sachs regarding Irish Nationwide
 - Limited verbal information from the Ministry of Finance and IFSRA
- We have not spoken to the management at any of the Irish Banks
- Scope has been evolving
 - Initially focused on Anglo and INBS, but now encompasses ILP, EBS and the effects on BoI and AIB given recent developments
- Must calibrate long-term impact on Ireland as a financial centre and implications for sovereign rating
- Every action should be assessed with respect to impact on share prices of AIB / BoI
 - Note rating agencies's concern that declining share price represents lack of confidence in the bank as a counterparty which can contribute to a downgrade
 - Impact on ability to raise capital
- Need to consider deposit guarantee in any event
- The following considerations are therefore preliminary and subject to further consideration



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Strategic Options

	Secured Lending Scheme / ELA	Good Bank, Bad Bank	Protective Custody of ANG / INWE	Guarantee for 6 Primary Regulated Irish Banks	Liquidation
Pros	<ul style="list-style-type: none"> ■ Converts non ECB-eligible collateral into liquidity ■ Deals with immediate liquidity problem / buys time ■ Leaves Irish Nationwide / Anglo Irish temporarily as going concerns ■ Benefits the whole financial system ■ "Positive" for Ireland Inc. from outsiders' point of view 	<ul style="list-style-type: none"> ■ Deals with the most problematic assets causing headline risk ■ Will help restore confidence and help banks carry on business ■ Promotes orderly unwind / minimises asset deflation 	<ul style="list-style-type: none"> ■ Deals decisively with the most problematic institutions ■ Demonstrates implicit commitment to Irish banks as a whole ■ Interim step before formal guarantee if needed ■ Protects senior / subordinated creditors ■ Deposit guarantee will stem outflows and may result in inflows 	<ul style="list-style-type: none"> ■ Best / most decisive / most impactful from market perspective ■ Deposit guarantee will stem outflows and may result in inflows ■ Protects senior and subordinated creditors 	<ul style="list-style-type: none"> ■ Does not have an immediate cost to the Exchequer, but likely to be longer term implications
Cons	<ul style="list-style-type: none"> ■ Does not deal with problem that monoline / lowly rated business are unlikely to work ■ Irish Government could / will likely end up funding the entire Anglo Irish / Irish Nationwide balance sheets (€84bn ~ €120bn?). Even with zero usage by other Irish banks 	<ul style="list-style-type: none"> ■ No critical mass remaining at Irish Nationwide / Anglo Irish ■ Most complex option for Government – will require more time <ul style="list-style-type: none"> ■ Capital / liquidity hits (€80bn++) 	<ul style="list-style-type: none"> ■ Government ends up funding combined balance sheet ■ Irish tax payer exposed beyond shareholders' equity ■ Potential negative impact on share price of Bank of Ireland / Allied Irish Banks / ILP 	<ul style="list-style-type: none"> ■ Will market find it credible given scale (€500bn+)? ■ Can Ireland afford it? ■ Ratings impact? ■ Will it pass the test with other EU countries given broader implications? ■ How long will it last? 	<ul style="list-style-type: none"> ■ Significant read across to other banks ■ Mark assets down at other banks to liquidation levels ■ Capital and liquidity impact ■ Investor perception of Ireland Inc. and financial stability more generally ■ Perception that authorities not in control of developments
Considerations	<ul style="list-style-type: none"> ■ Commercial vs. penal rate funding ■ Over-collateralisation possible ■ Appropriate tenure ■ Shareholder control maintained as well as management structure ■ ELA or AIB / BoI ECB access could also be used 	<ul style="list-style-type: none"> ■ Should it be available to all Irish banks? ■ Can be structured to place government capital injection ahead of existing Equity ■ If this is the chosen path, most likely to be a second stage solution ■ Will require guarantee for senior / subordinated debt holders 	<ul style="list-style-type: none"> ■ Irish Nationwide / Anglo Irish to be taken into state control ■ Will require guarantee for senior / subordinated debt holders ■ Put business into run-off 	<ul style="list-style-type: none"> ■ Irish Nationwide / Anglo Irish to be taken into state control ■ All cards played immediately ■ Equity market perception? 	<ul style="list-style-type: none"> ■ Option discounted due to impact on state / other financial institutions



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Strategic Options

	Secured Lending Scheme / ELA	Good Bank, Bad Bank	Protective Custody of INWE / ANG	Guarantee for 6 Primary Regulated Irish Banks	Liquidation
Quantification	<ul style="list-style-type: none"> ■ Anglo has €3.3bn of loans on the watchlist ■ A 10% fall in commercial property value would result in an additional provision of €7bn ■ €23bn liquidity deficit by the end of the year ■ Additional €17bn of liquidity expected to be lost once information becomes public ■ → Total €40bn 		<ul style="list-style-type: none"> ■ INBS has €11.7bn of loans ■ Writedowns of 30% - 60% results in an impairment of €3.6bn - €7bn ■ Liquidity of €3bn to end-2008 out of total creditors of €16bn ■ Losing €50m - €100m of deposits per day 		
Legal	<ul style="list-style-type: none"> ■ Relatively straightforward (subject to checking existing powers) ■ NTMA to be granted relevant powers in current bill ■ Property structured, should not encounter a state aid issue (commercial terms and as non-selective as possible) 	<ul style="list-style-type: none"> ■ Very difficult to identify and address all legal issues in immediate timeframe ■ New legislation required 	<ul style="list-style-type: none"> ■ Legislation in hand ■ Preferred share approach could be accommodated in timeframe ■ Guarantee based on either <ul style="list-style-type: none"> (a) rescue aid basis, applying for approval for restructuring aid within 6 months; and/or (b) Art 87 (3)(b) to remedy serious disturbance to the economy ■ Legislative power to be drafted into current bill to provide further guarantees if necessary ■ Clear statement by Minister of intent to provide further aid as necessary should not attract additional state aid problems 	<ul style="list-style-type: none"> ■ Legislation in hand ■ Preferred share approach could be accommodated in timeframe ■ Rescue aid rules applicable to the intervention with Anglo / INBS ■ General guarantee to banking system would be based on Art 87(3)(b) – serious disturbance to the economy (systemic risk) ■ Should investigate whether on basis of Art 87(3)(b), guarantee limited to the 6 banks would be allowable ■ Danger that the Commission would not accept this basis for the general guarantee 	<ul style="list-style-type: none"> ■ N/A



Draft Preliminary Analysis

Strategic Options

	Secured Lending Scheme	Good Bank, Bad Bank	Protective Custody of INWE / ANG	Guarantee for 6 Primary Regulated Irish Banks	Liquidation
Impact on Primary Regulated Banks	<ul style="list-style-type: none"> ■ ILP – Potentially €4bn limit on collateral available under ECB facility, insufficient to fund forthcoming funding needs so ILP likely to be part of the solution ■ AIB / Bol – Deposit base fine, could use ECB facility to fund ILP ■ AIB / Bol could be encouraged to buy out ILP / EBS with State funding ■ EBS theoretically viable as an independent institution, though concerns remain regarding funding given size and scale 				
Impact on Non-Primary Regulated Banks	<ul style="list-style-type: none"> ■ Restrict collateral to commercial real estate and to primary regulated banks to deter foreign-owned institutions 	<ul style="list-style-type: none"> ■ N/A 	<ul style="list-style-type: none"> ■ Other institutions scope for possible complaints but no legal grounds ■ Long-term reputational issues for Ireland 	<ul style="list-style-type: none"> ■ Other institutions scope for possible complaints but no legal grounds ■ Long-term reputational issues for Ireland 	<ul style="list-style-type: none"> ■ N/A
Systemic European Impact	<ul style="list-style-type: none"> ■ No effect 	<ul style="list-style-type: none"> ■ No effect 	<ul style="list-style-type: none"> ■ No effect 	<ul style="list-style-type: none"> ■ Most contentious 	<ul style="list-style-type: none"> ■ No effect
Timing	<ul style="list-style-type: none"> ■ Immediate liquidity issues need to be addressed ■ Maximum 2 week window, more likely 7 – 9 days ■ No reason to expect significant liquidity improvement in the market ■ TARP issues in US still to work through ■ 30 September quarter end money market redemptions will prevent any meaningful change in market conditions 				



Draft Preliminary Analysis

Market Backdrop For Financial Institutions

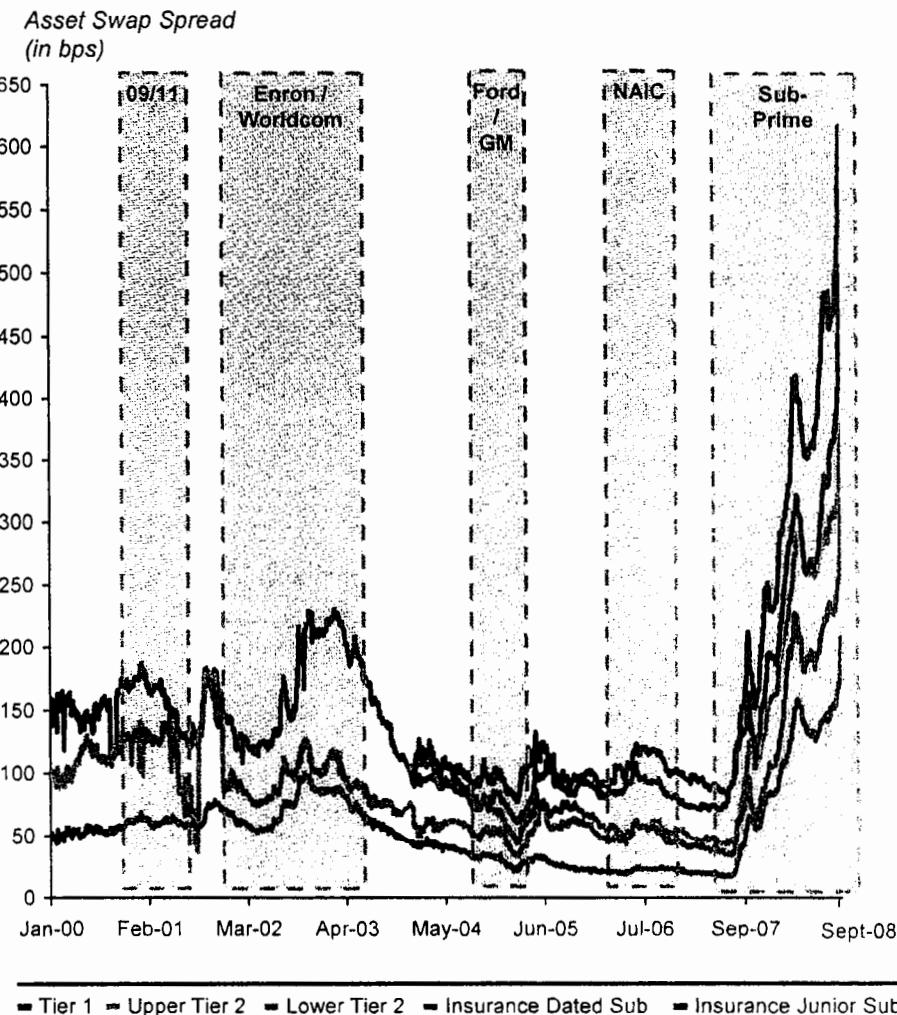
Severe Stresses In The Financial Markets Remain Amidst Volatility

Aggregate Spread Performance By Asset Class

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

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

Current Cycle Much More Severe Than Previous

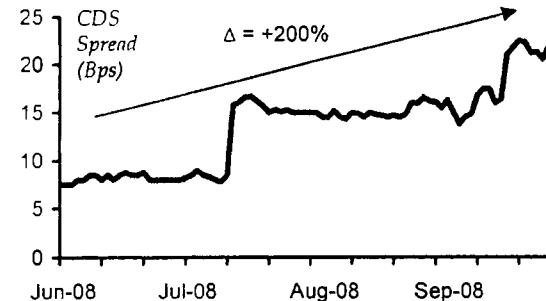


Draft Preliminary Analysis

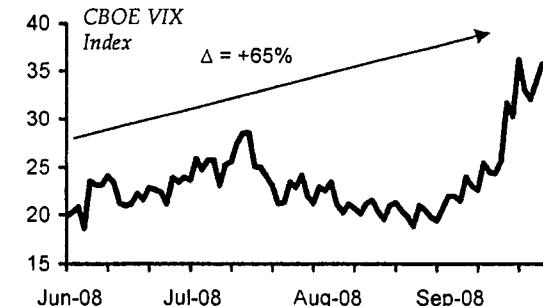
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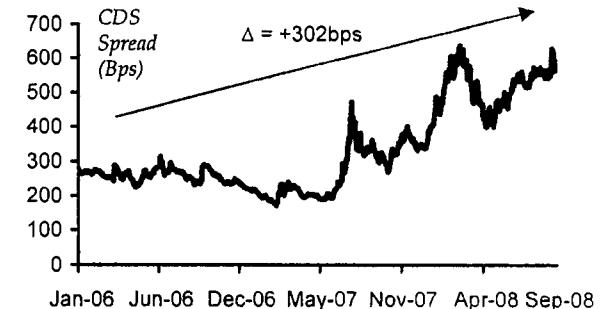
10-Year US Treasury CDS



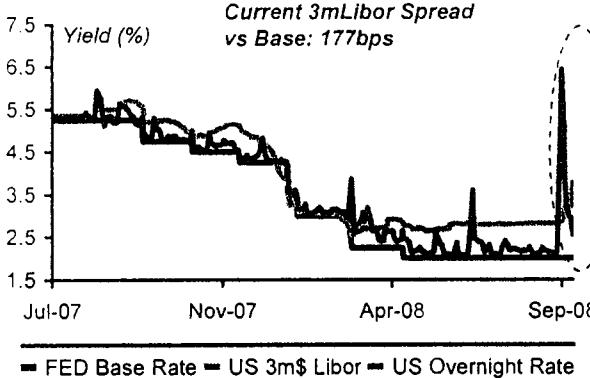
VIX Volatility Index



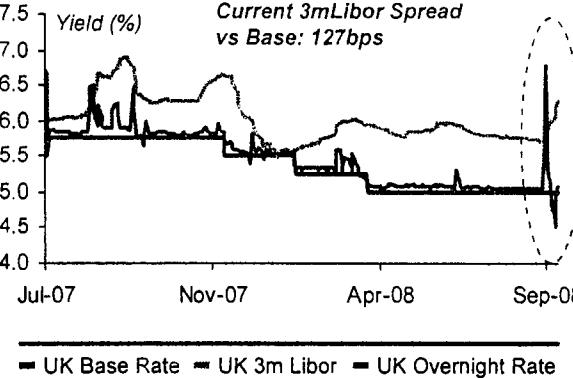
iTRAXX Cross-Over



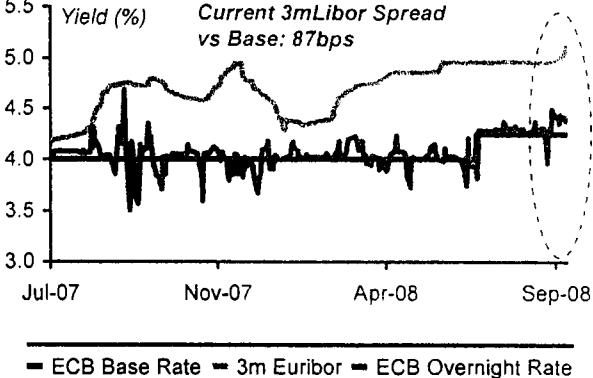
US Interbank Rates



UK Interbank Rates



EUR Interbank Rates



Draft Preliminary Analysis

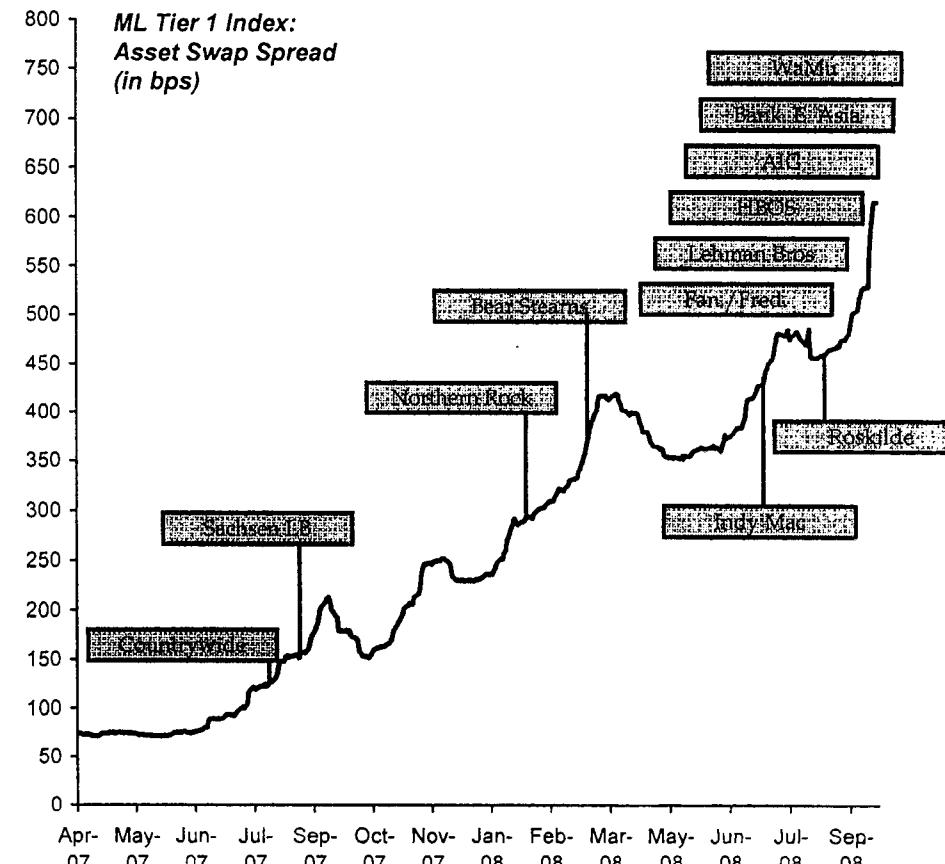
Market Backdrop For Financial Institutions

Acceleration of Bank Failures & Impact on Capital Markets

List of Key Bank Failures

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

Bank Failures Substantially Impact Credit Markets



Draft Preliminary Analysis

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