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REPORT of the Joint Committee of Inquiry into the Banking Crisis

Houses of the Oireachtas
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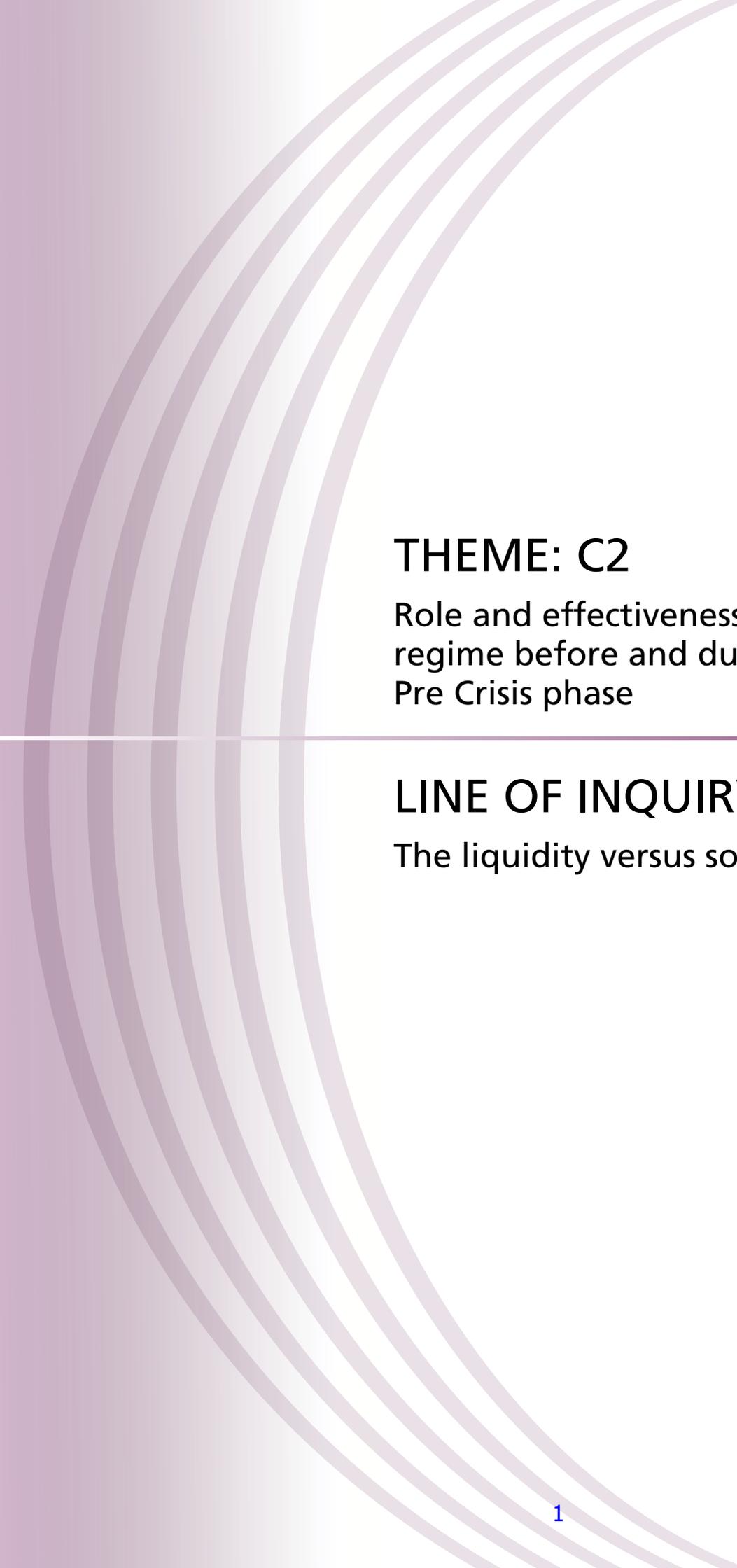
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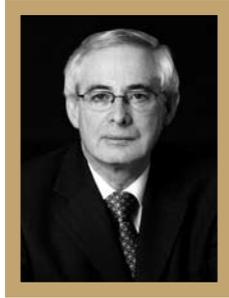
THEME: C2

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

LINE OF INQUIRY: C2c

The liquidity versus solvency debate

Governor's Foreword



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

The euro area economy grew by 2.7 per cent in 2007, which is above its generally agreed sustainable growth rate. Growth was broad based, with contributions from both domestic and external demand, but there was a sharp decline in consumer sentiment towards the end of the year. This pattern appears to have continued into the first half of 2008 and, while exports have continued to hold up, for 2008 as a whole the euro area should see growth of about 1¼ per cent. The US economy experienced a more significant slowdown in the final months of 2007 and growth is expected to be somewhat weaker again in 2008. The risks to the growth outlook are on the downside in both the US and the euro area.

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

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

confirmed by the stress testing exercises we have carried out with the banks.

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

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

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

Summary

The overall assessment is that financial stability risks have on balance increased since the CBFSAI's Financial Stability Report 2006. The 2006 Report identified three major domestic vulnerabilities for financial stability: strong credit growth and rising indebtedness, upward momentum in house prices and the adverse impact of increasing repayment burdens on the health of the household sector. Since then, there has been a number of welcome improvements with respect to domestic risks. First, the upward momentum in residential property prices has abated, thus reducing the vulnerability posed by the previous substantial increase in house prices. Second, the rate of credit growth has eased and the rate of accumulation of private-sector indebtedness has moderated accordingly. However, issues have arisen with respect to the domestic economy arising from the longer-term deterioration in competitiveness, the moderation in the contribution of residential construction-sector activity to overall growth, and the possible effects of international financial-market turbulence. This turbulence arose as problems in the US subprime mortgage market broadened into a repricing of risk in a number of financial markets. Although this is a transition to a more normalised pricing of risk, the possible spillover effects from this adjustment could be important for financial stability both at home and abroad because of the potential impact on the banking sector and on the economy. However, the central expectation, based on an assessment of the risks facing both the household and non-financial corporate sectors, the health of the banking sector and the results of recent in-house stress testing is that, notwithstanding the international financial market turbulence, the Irish banking system continues to be well placed to withstand adverse economic and sectoral developments in the short to medium term.

Overall Assessment

Increased international uncertainty is associated with the fallout arising from problems in the subprime mortgage sector in the US. In early-2007, there was a sharp weakening in global equity markets, where the key driver was a negative re-assessment of the economic outlook in the US. This developed, later in the year, into the period of severe market turbulence mentioned above and was characterised by rising volatility, declining liquidity and a sharp repricing of risk. An important contributing factor was a significant heightening of

concern, from mid-2007 onwards, about the exposure of a wide range of mortgage-related securities and structured credit products to mounting losses in the US subprime mortgage market. Uncertainty about the size and distribution of credit risk exposures and related losses caused risk aversion to heighten further. This triggered a sharp spillover from the ongoing repricing of credit risk generally to particularly negative sentiment towards the market for collateralised short-term financing. This disrupted banks' liquidity flows, as asset-backed commercial paper (ABCP) became increasingly difficult to rollover. Allied to the uncertainty about banks' exposures to risky assets, concerns about counterparty risk heightened and problems began to spillover to the interbank market. A number of central banks, led by the ECB, reacted promptly to alleviate these problems through the provision of substantial liquidity injections. These actions alleviated the problems at the very short-end of the interbank market, although longer-term rates have not yet fully adjusted and spreads between these rates and policy rates remain relatively wide. Overall though, the transition to a more normalised pricing of risk will be beneficial for international financial stability in the long run.

The possible spillover effects from recent volatility in financial markets are important for financial stability because of the potential impact on the real economy, both globally and in Ireland. The risks from the international economy relate to the heightened uncertainty about global growth prospects and increased investor nervousness, with the possibility that risk premia will rise and credit conditions will be tighter with adverse consequences for economic growth across the major regions. Forecasts from the major international economic institutions suggest that the downside risks are most pronounced for the US. While the resilience of the global and euro area economies should be helped by the fact that both were growing solidly before the recent outbreak of market turbulence, a marked slowdown in US growth would remove considerable impetus to activity in the rest of the world. In particular, the significant trade and investment links between Ireland and the US leave the Irish economy particularly vulnerable to any downturn in growth in the US. This international risk to the Irish economy is in addition to continuing issues about high and volatile energy prices and the possibility of further strengthening of the euro

against the US dollar as part of a correction process for international current-account imbalances.

The international banking system has been negatively affected by recent events, both directly through banks' losses on their US subprime assets, and indirectly through holdings of investments exposed to US subprime losses, from credit commitments to conduits/special purpose vehicles, and from a general disruption to business. In this respect, the domestic banks report no significant direct exposures to US subprime mortgages and very limited exposures through investments and credit lines extended to other financial companies or special purpose vehicles. The domestic banks' shock absorption capacity has not been much reduced by these events.

Regarding the main domestic development, the significant easing in residential house price growth has reduced some of the key concerns noted in last year's Report. While house prices increased nationally by almost 12 per cent on average in 2006, they slowed significantly in the second half of the year. The slowdown continued in 2007 and prices are now about 3½ per cent lower on a year-to-date basis. These developments should be assessed against the gains in house prices in recent years. Furthermore, concerns that house prices would move further out of line with fundamentals and that housing affordability would worsen have lessened since last year's Report. Regarding future house price developments, factors such as investors' participation in the property market, the sustainability of current rates of immigration, the future direction of monetary policy and the performance of the labour market are all important. The underlying fundamentals of the residential market continue to appear strong. The central scenario is, therefore, for a soft, rather than a hard, landing.

The rate of accumulation of debt by households and non-financial corporates has continued to ease for a second successive year. However, the current rate remains high by international comparison. The ratio of private-sector credit to GNP in Ireland had increased in recent years reflecting the level of economic activity generally and, specifically, the increased demand for housing and investment activity. Although a high level of indebtedness increases the vulnerability of the private sector to income and interest-rate shocks, there are also important mitigating factors such as the sector's overall net worth and the positive outlook for the economy which, when assessed alongside the slowdown in borrowing, reduce this vulnerability somewhat.

Households' repayment burdens have stabilised somewhat since the publication of last year's Report but the outlook remains uncertain. Repayment burdens had stabilised because households' disposable incomes continued to grow robustly and budgetary tax changes helped offset the additional costs of some earlier interest-rate increases. The household sector remains, however, vulnerable to higher interest rates because the bulk of both the stock of existing mortgages as well as the flow of new mortgage loans are at variable rates.

Against a more uncertain international backdrop, the indications are that the domestic economy continues to perform solidly. The overall picture for economic growth is generally satisfactory in the current uncertain international environment and follows a period of high growth. On the positive side, economic fundamentals – a good budgetary position, strong employment growth, an adaptable economy – continue to be sound. The outlook is for some deceleration of economic growth in 2008, but growth projections remain reasonably positive by international standards. As economic growth slows, an upturn in the unemployment rate is likely. However, this is expected to be modest and the forecast is for the economy to remain at close to its full-employment position. Moreover, as domestic output growth weakens, inflationary pressures in the economy are expected to reduce.

Despite this relatively favourable economic environment, a number of risks remain and the concern is that the economy may be affected by several of these risks at the same time. From a domestic perspective, there are continuing concerns about the high, if declining, share of the construction sector in economic activity and the longer-term losses of competitiveness. The high share of construction is expected to decline gradually in the coming years, with the reduction in residential activity offset in part by continued strong growth in public sector and private non-residential construction. The deterioration in competitiveness reflects a number of factors including rising prices and production costs relative to our trading partners, the strengthening of the euro exchange rate, particularly against the dollar, and weaker productivity growth. Given the openness of the economy, Ireland is particularly vulnerable to global shocks. In addition to the current market turbulence, there are continuing issues about high and volatile energy prices as well as the further strengthening of the euro against the US dollar as part of a correction process for international current-account imbalances and uncertainties relating to the US economy.

There are two additional developments since the last Report which merit consideration. First, in contrast to the residential market, commercial property prices continue to appreciate at relatively high rates. The commercial property market performed strongly across all sectors (i.e., office, retail and industrial) in 2006 and early-2007, with capital appreciation reaching an annual rate of 24 per cent last year. The concern was not only that capital growth rates in the commercial property market were high, but they also appeared to have diverged from the corresponding rental growth rates such that yields were driven to unprecedented low levels. It is welcome, therefore, that the pace of capital appreciation has begun to ease, the divergence between capital and rental growth has begun to decline, and the long-run decline in yields in Ireland appears to mirror the international experience.

Second, there is the combined effect on the banking sector of low net interest margins and higher funding costs in an environment of lower volume growth. A combination of a slower housing market, somewhat slower economic growth and the impact of the current turbulence in financial markets on banks' willingness to supply loans, could all contribute to lower volume growth in the future. In the context of these vulnerabilities and risks to the economic outlook, a healthy banking system with good shock-absorption capacity is needed to support a stable financial system. The health of the banking system remains robust when measured by the usual indicators: solvency, profitability, liquidity, asset quality and market indicators. The central expectation, based on an assessment of the risks facing both the household and non-financial corporate sectors, the health of the banking sector and the results of recent in-house stress testing is that, notwithstanding the international financial market turbulence, the Irish banking system continues to be well placed to withstand adverse economic and sectoral developments in the short to medium term.

CBFSAI's Mandate

The CBFSAI's legal mandate is to contribute to the maintenance of financial stability in both Ireland and the euro area. Financial stability is an issue of major importance for both the Central Bank and the Financial Regulator. The key elements in the discharge of this mandate are to raise awareness of financial stability matters through initiatives like the publication of the annual financial stability report, maintaining a dialogue with domestic credit institutions in order to highlight issues for the financial system and, finally, to continue

to develop procedures to deal with potential disruptive events and to facilitate an orderly resolution. In relation to cross-border financial institutions, the Central Bank and Financial Regulator maintain ongoing dialogue with their counterpart central banks and financial regulators.

Economic and Sectoral Commentary

Domestic Macroeconomic Outlook

Economic growth in the Irish economy remains strong and labour market conditions remain favourable, although the projections for growth in 2007 have been revised downwards marginally since the last Report. Last year the volume of GNP increased by 6.5 per cent with a corresponding increase in GDP of 5.7 per cent. While these rates of growth were somewhat above the estimated potential growth rate of the economy, slower growth is expected during 2007 and 2008. This partly reflects developments in the residential construction sector, the output of which appears to have peaked during 2006. Private consumption growth is also expected to moderate somewhat next year as the impact of maturing SSIA funds lessens. As a result, GNP growth is projected to fall to around 4³/₄ per cent this year with a further decline to around 3¹/₄ per cent in 2008. The corresponding projections for GDP growth in 2007 and 2008 are 4³/₄ per cent and 3¹/₂ per cent, respectively.

The labour market continues to perform well, although the projections for unemployment have been revised upwards slightly since the publication of the last Report. Total employment increased by 4.4 per cent in 2006, with particularly strong increases in construction (9.7 per cent), health (8.2 per cent) and wholesale and retail trades (4.6 per cent). Despite some well-publicised adverse employment news recently, the aggregate data indicate that the strong labour market performance looks set to continue. As economic growth slows, an upturn in the unemployment rate is expected. However, this is expected to be modest and the forecast is for the economy to remain at close to its full-employment position.

Domestic Macroeconomic Risks

Despite the relatively favourable economic outlook, a number of significant risks remain. First, from a domestic perspective, there are concerns about the continuing high share of the construction sector in economic activity. This is expected to decline gradually in the coming years with the reduction in residential activity mitigated in part by continued strong growth in public-sector and private-non-residential construction. However, a sharper-than-expected fall in housing output

would have a negative impact on both GDP growth and employment.

A second domestic risk relates to longer-term losses of competitiveness. While the economy was in an extremely strong, but probably unsustainable, competitiveness position at the beginning of the current decade, the situation has subsequently deteriorated. As already noted, this has been due to a number of factors including rising prices and wages relative to our main trading partners, an appreciation of the exchange rate and lower productivity growth. While the overall competitiveness position of the economy does not appear to be too strained, judging from data on inward FDI flows, nevertheless, a continuation of underlying trends could lead to a more significant adjustment in the longer run.

International Macroeconomic Risks and Financial Market Developments

Given the openness of the Irish economy, its financial system is potentially vulnerable to global shocks and to the current developments in the international financial system. The most significant issue since the last Financial Stability Report has been signs of significant distress in the US subprime mortgage sector, which came to a head in early- to mid-2007. From late-June onwards, concerns were heightened about the exposure of a wide range of mortgage-related securities and structured credit products to mounting losses in the US subprime mortgage market, causing problems in the market for asset-backed commercial paper (ABCP), where investors were reluctant to rollover financing given the increased nervousness about the associated risks. Uncertainty about the size and distribution of credit risk exposures and related losses affected market conditions, and what started as a credit market sell-off quickly evolved into a bout of severe market turbulence characterised by rising volatility, declining liquidity and a sharp repricing of risk. Risk aversion heightened further when the problems – which, up to then, had been concentrated in hedge funds and US financial institutions involved in mortgage business – began to spread to the more broad-based banking sector internationally especially through banks' connections with ABCP conduits or structured investment vehicles. Thus, the generalised ongoing repricing of credit risk caused a drying up of liquidity in the collateralised short-term commercial paper market.

Allied to the uncertainty about banks' exposures to the repricing of risky assets, concerns about counterparty

risk heightened from early-August and problems began to spillover to the interbank market. With banks becoming very reluctant to lend to one another, even at very short maturities, overnight rates began to rise sharply. A number of central banks – led by the ECB – reacted promptly to alleviate problems in the interbank money market through the provision of substantial liquidity injections. These actions succeeded in alleviating the problems at the very-short end of the interbank market, with overnight rates reverting to their earlier levels. Longer-term rates, however, have not yet fully adjusted and spreads between these rates and policy rates remain relatively wide. This is likely to place upward pressure on the cost of borrowing, as will the widening of spreads on lower-rated corporate debt. There is also the possibility that creditworthy borrowers will face some rationing of credit which could have adverse implications for global growth prospects.

Prior to the above events, the outlook for the global economy was favourable but there were also risks to the outlook which could have knock-on implications for the domestic outlook. The assessment made prior to the US subprime crisis was that the international macroeconomic environment had remained supportive of financial stability given its robust pace of expansion, in spite of high and volatile oil prices, a sharp slowdown in the US housing market and earlier financial market turbulence. Risks to the inflation outlook, however, had been tilted to the upside, relating to increased capacity utilisation, high oil prices and the prospect that wage pressures would intensify as labour markets improved. As a result, monetary policy had generally been either in a stable or tightening phase. While a broader economic assessment of the implications of recent events in international financial markets depends on the duration of disturbed market conditions and the associated uncertainty, the current assessment is that the overall outlook for growth remains positive although clearly downside risks have risen somewhat. A key consideration is that, even if market liquidity improves, risk spreads are likely to remain higher on a long-term basis than they have been in recent years.

Forecasts from the major international economic institutions suggest that the downside risks are most pronounced for the US. This reflects the view that the problems in financial markets are likely to intensify the downturn in the US housing market, where forward-looking indicators of conditions were pointing lower even before the recent turbulence began. In addition to the direct impact of US housing market weakness on

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

Overview

International

- Difficulties are continuing in international financial markets with credit availability restricted, the cost of funds elevated and no near term prospect of markets returning to their pre-crisis levels. The general view is that there is no immediate prospect of a reversal of this position. The more optimistic commentaries refer to the current position as being 'the end of the beginning'.

- The problems that began in August 2007 with US sub-prime mortgage lending have worked their way throughout the financial system. The banks that originated many of sub-prime mortgage products have had to bring losses to book, currently estimated at €500 million, but with the IMF estimating eventual losses at \$1 trillion. Concerns as to where losses will eventually be realised have led to a reluctance by investors to lend money to the financial sector, putting pressure on banks that fund their retail lending from wholesale financial markets.

- Against this background the last year has seen a succession of bad news - nationalisation of Northern Rock in the UK, virtual collapse of Bear Stearns in the US, rescue of SachsenLB and IKB in Germany, takeover of Roskilde Bank in Denmark by a combination of the Central Bank and other Danish banks and fears that in the US, Fannie Mae and Freddie Mac, which together own or guarantee \$5.3 trillion in US mortgages, may have to be re-nationalised. Such events have seriously weakened investor sentiment.

- 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 billion in finance over the next few months have added to the negative picture. 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 will not be able to get money when they need it.

Ireland

- Though having no direct exposure to US sub-prime lending, Ireland cannot not hope to completely escape the impact of international developments. The tightening and increased cost of credit, which has coincided with a significant correction in construction activity, has thrown into sharp relief the reliance of domestic retail banks on wholesale financial markets to finance mortgage and property lending.

- - There is little international investor appetite for investment in Irish financial institutions, which are perceived to be vulnerable to the real economy impacts of the credit crisis and correction in construction activity. The resulting 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. A series of recent reports (CB Richard Ellis describing sharp fall in commercial property deals down from €1.9bn to €0.4 bn, Goldman Sachs pointing to likely increased impairment of loans by Irish banks reducing 34pc off their earnings estimates for the sector between 2008 and 2010) have underlined the position.

Summary

- 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 to-date 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; the level of lending to (x date), at €r billion, though down on the comparable period in 2007 would tend to support the contention that credit continues to be available, though clearly lending conditions are tightening.

- Key to sustaining the position of Irish banks this far has been the maintenance of confidence. The strong endorsement of the position of the Irish banks in terms of capitalisation, liquidity, etc., by the Central Bank, IMF and OECD at the commencement of the present period was vitally important. Going forward, the maintaining confidence is vital 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 assessment underlines the importance of Government's role in maintaining confidence and providing a stable economic and financial climate through sound management of the economy, prudent responsible budgetary policies and a focus on labour cost competitiveness

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

A more detailed note is attached.

Financial Market Developments

International

International financial markets remain depressed reflected in massive falls in bank share prices, little investor interest in financial markets and continuing elevated interest rates 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** crises 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 subprime 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 subprime 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 bodies.
- In Europe, **collapse in the value of 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 0.72% 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 was

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

approximately 0.6% at the start of the month. 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 available² as the ECB tightens its lending criteria. 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 requirement;** 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 monies.. By the end of this year, big banks and investment banks 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 (see attached graph at appendix 1) especially banks, 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 (details attached at appendix 2) and spillover 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 avoided 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 vulnerabilities of our 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.
- The share prices of individual financial institutions have been highly volatile, in general the share prices of individual banks are worth about 1/3 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, figures released by the Central Bank on 29 August show that the annual rate of increase in private-sector credit reached a six-year low of 13.3 per cent in July 2008. There has been a decline in levels of lending; mortgage lending has declined from €x billion in the first six months of 2007 to €y billion in the same period in 2008, a decline of r%, and most banks have radically altered their loan product line and required 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 €24.5 bn to €31 bn, domestic banks have reduced their dependence from €15 bn to €13 bn.

Financial Stability Report 2008

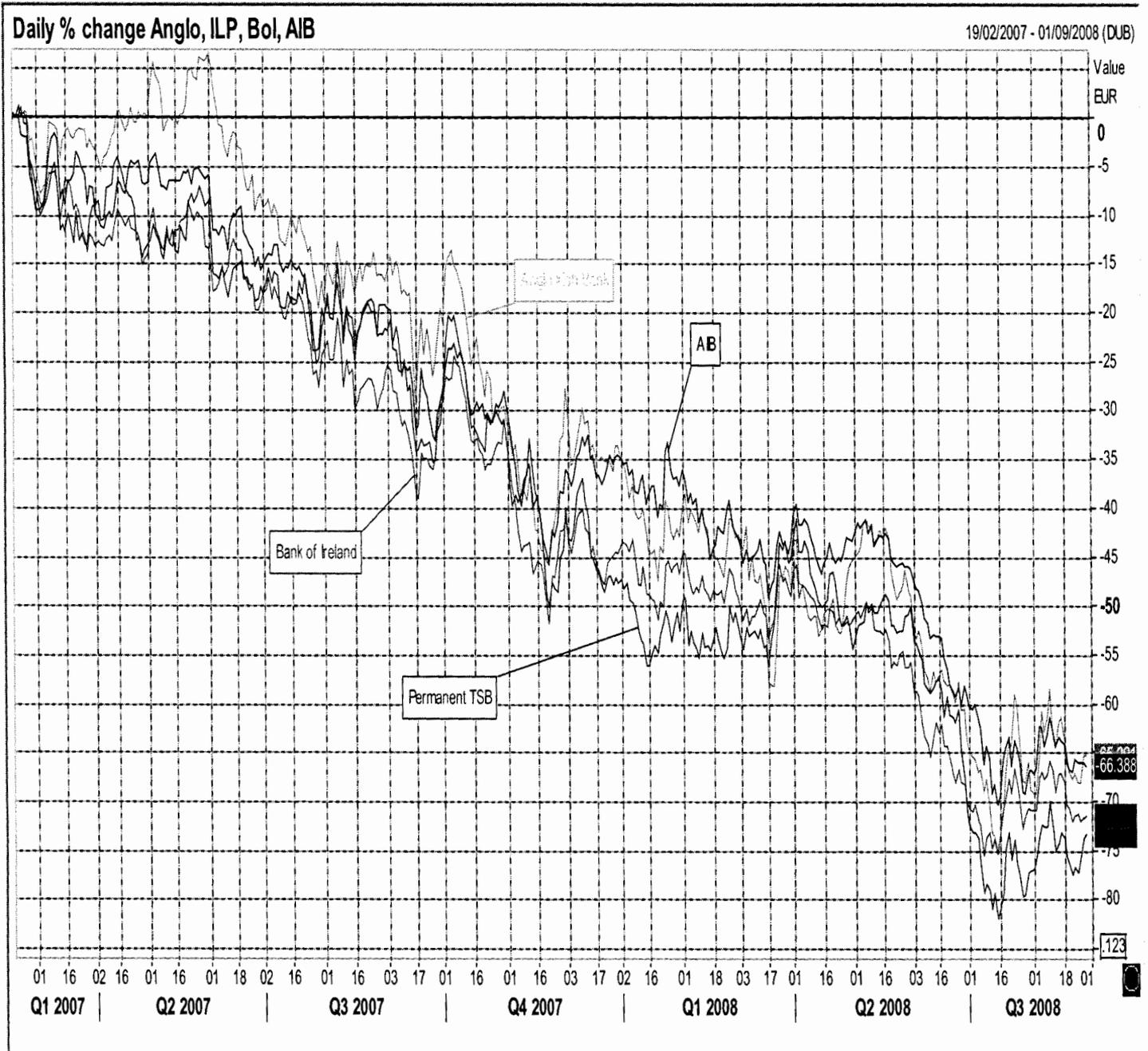
The CBFSAI's Financial Stability Report (FSR) for 2008 will be published in mid November. This arises from our membership of the European System of Central Banks which requires the ECB and national Central Banks to foster financial stability in the euro zone. The objective of the Report is to set out the CBFSAI's overall assessment of the stability of the domestic financial system; it does not relate to monetary policy matters. The FSR provides the CBFSAI's view on the economic outlook generally and macroeconomic risks arising. It focuses on issues for the Domestic Financial System and its overall health. The overall conclusion of the FSR

for 2007 was that the shock-absorption capacity of the banking system left it well placed to withstand pressures from possible adverse economic and sectoral developments. Clearly the extended period of dislocation in financial markets, spillover 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. [The emergence of this report shortly before the Budget will make it important that the key messages are responded to.]

August 2008

cc Secretary General, Mr Cardiff, Ms Herbert

Share performance of Irish banks from the highs of February 2007



Appendix 2

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

Daily QBKIR5YEUAM=FN, QANGL5YEUAM=FN, QBSCT5YEUAM=FN, QAIB5YEUAM=FN, QHSBA5YEUAM=FN

18/06/2007 - 03/09/2008 (LON)



Note to Witness

This document, *Crisis Management: Selected Extracts from 5 Banking Reviews*, was prepared by the Banking Inquiry Secretariat as an aid to the Witness.

It is a compendium of selected extracts from the findings of the five reviews commissioned or undertaken by either Government or the Houses of the Oireachtas on the banking crisis.

The headings, sub-headings and other categorisations used throughout were prepared by the Inquiry Secretariat for indicative purposes only and do not necessarily correspond with those used in the five reviews.

The Witness is advised to give primary reliance to the original reviews referenced in this document when preparing testimony; the abbreviations used and associated titles are as follows:

Abbreviation	Title of Banking Review
'Honohan'	The Irish Banking Crisis – Regulatory and Financial Stability Policy 2003 – 2008 A Report to the Minister for Finance by the Governor of the Central Bank <i>31 May 2010</i>
'Nyberg'	Misjudging Risk: Causes of the Systemic Banking Crisis in Ireland Report of the Commission of Investigation into the Banking Sector in Ireland <i>March 2011</i>
'PAC'	Houses of the Oireachtas Committee of Public Accounts: Report on the crisis in the domestic banking sector: A preliminary analysis and a framework for a banking inquiry <i>July 2012</i>
'Regling and Watson'	A Preliminary Report on the Sources of Ireland's Banking Crisis <i>2010</i>
'Wright'	Strengthening the Capacity of the Department of Finance – Report of the Independent Review Panel <i>December 2010</i>

C1 - Pre-Crisis Situations

Pre-crisis – Context Statistics and Precipitative Role of D/Finance

GDP Growth

From 1988 to 2007, real GDP expanded by 6 per cent per annum on average (reaching double digit growth during 1995-2000). Unemployment plummeted from 16 per cent (on the ILO basis) in 1994 to 4 per cent in 2000 – essentially full employment for the first time in modern history (*Honohan, p. 21*)

Department of Finance's role

The Department paid insufficient attention to broader macro-economic risks. While suitably direct on the risks of excessive spending and tax relief, annual departmental advice to Cabinet generally did not consider the broader set of macroeconomic risks. It did not, for example, consider the risks related to the extraordinarily expansive monetary conditions, which substantially heightened the risks of pro-cyclical fiscal action identified by the Department. This too, represents a significant deficiency. (*Wright, p. 30*)

Instead of analysing and stressing the nature of macroeconomic risks, the Department relied on the views of bodies such as the Central Bank, which was tasked with guarding financial stability. The Department of Finance ... was reluctant to oppose packages that included outcomes that retained labour peace for the economy as a whole. (*Wright, p. 25*)

Faced with politically-driven tax and spending priorities, the Department was not forceful in seeking changes in other areas that could compensate for inflationary, pro-cyclical, or tax base narrowing effects. (*PAC, p. 108*)

The Panel reviewed in detail the annual June Memoranda to Cabinet on Budget Strategy. Generally speaking, we found that advice prepared by the Department for Cabinet did provide clear warnings on the risks of pro-cyclical fiscal action. (*Wright, p.5*)

However, it should have adapted its advice in tone and urgency after a number of years of fiscal complacency. It should have been more sensitive to and provided specific advice on broader macroeconomic risks. And it should have shown more initiative in making these points and in its advice on the construction sector, and tax policy generally. (*Wright, p. 6*)

The June Memoranda clearly and consistently warned the Cabinet of the effects of pro-cyclical policies and high levels of spending. ... [However,] no single analysis integrated all risks (*Wright, 3.23*)

While the DoF identified various risks to the economy and to its budgetary forecasts, no single comprehensive analysis integrating all of these risks (including risks emanating from the financial sector) and assessing their implications for the economy into the medium-term was carried out. (*Nyberg, p. 69*)

The Department was very clear on the risks to the Exchequer of a downturn in the construction sector, providing specific estimates of the fiscal risks, and clear advice on the dangers of relying on related tax revenues. However, there was no analysis or advice on the broader risk to the tax system from a more general downturn in economic

Crisis Management: Selected Extracts from 5 Banking Reviews

activity from levels created in part by pro-cyclical fiscal policy. (*Wright, p.32*)

The DoF was generally conscious of the need to rein in both general government expenditure and tax reliefs that favoured the property market. For example, a 2004 brief prepared for the new Minister for Finance urged restraint in terms of growth in expenditure and tax reliefs and emphasised the need for base-broadening taxation measures. It also stated that competitiveness should be maintained by controlling the domestic cost base and identified the need for capacity to respond to economic shocks. However, the brief was silent in relation to credit growth. (*Nyberg, p. 69*)

Despite repeated expressions of concern over the construction sector in Budget Memoranda to Cabinet and elsewhere, the Department did not organise a strategic response to the problem, or identify a full range of options to moderate activity in the sector. (*Wright, p. 31*)

When a 2007 ESRI commentary suggested that a housing bubble had formed, the Department's briefing note suggested that a soft landing was the likely outcome. (*Nyberg 4.5.8*).

Following concerns expressed by the Department of the Environment in 2005 on the effect of 100% mortgages on the indebtedness of households, the Department consulted the Financial Regulator (*Nyberg 4.5.9*). In its response to the Department of the Environment, the Department took the position that this was a consumer matter rather than a financial stability one, and that consumer caution and provision of appropriate information would prevent the matter causing extensive problems. Secretary-General Cardiff repeated this view in evidence to the Committee in 2010 (*PAC 6/5/2010 at p. 59 and PAC, p. 111*).

Despite mounting concerns about the fiscal and macroeconomic risks caused by over-reliance on construction and the tax incentives and credit that fuelled it, the Department did not present cautionary arguments forcefully enough to the Minister and Government. In the face of repeated Government rejection of the Department's advice for moderation and reduction of property-based incentives, the Department did not organise a strategic response or prepare alternative approaches for moderating construction activities. (*Wright, 3.8 and PAC, p. 109*)

The CBFSAI could have privately expressed concerns about mounting risks to financial stability to the Department of Finance. There is no evidence that it did (*Nyberg 4.4.9*). The Secretary-General of the Department was an *ex officio* member of the board of the FSAI. (*PAC, pp. 98-9*)

Department of Finance's Skillsets

The transfer of treasury operations to the NTMA helped create a very capable institution with a very broad remit. However the change weakened the skills set in the Department of Finance on finance and banking. This impaired the Department's capacity to respond to the banking crisis. (*Wright, p. 40.*)

When the banking crisis broke, the Department had neither the time nor the resources to conduct in-depth investigation of issues. This reflected shortages of skills in the requisite disciplines and inadequate knowledge of underlying developments in the sector. (*Wright, p. 33*)

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It [DoF] lacked specialist staff and while it gave advice on the negative effects of the Government's tax policies over the years leading up to the crisis, it did not perform quantitative analysis on the broader risk to the tax system. (*PAC, p. 106*)

One possible consequence of the "silo think" was that the DoF, discouraged from interfering in the work of the independent FR and CB, remained seriously underweight in professional financial expertise and engagement. The Commission considers it likely that the lack of overall analysis and responsibility in so many Irish public institutions may have allowed a number of warning signs to remain undetected. (*Nyberg, p. 97*)

Pre-crisis – Precipitative Role of the Construction and Property Sector

High-Level Drivers

Macroeconomic and budgetary policies contributed significantly to the economic overheating, relying to a clearly unsustainable extent on the construction sector and other transient sources for Government revenue (and encouraging the property boom via various incentives geared at the construction sector) (*Honohan, p. 15*)

The property boom was funded by cheap credit, increasingly sourced abroad in the form of interbank borrowing as the growth in domestic deposits failed to keep up with the explosion in credit. In some years, more than 80 per cent of the annual increment in credit went to fund a combination of house purchase and construction activity. While there were occasional warnings, on the whole, both domestic and international commentators took a benign attitude towards the risks that were building up. (*Wright, pp. 15-16*)

A perceived "permanent" downward shift in real interest rates and an upward shift in asset prices – accompanied in many cases by strong growth in household incomes – made mortgages an instrument of choice for balance sheet expansion. (*Regling & Watson, p. 15*)

Another factor, with even deeper roots, was the strong and pervasive preference in Irish society for property as an asset, and the fact that Ireland had never experienced a property crash. (*Regling & Watson, p. 5*)

Whether taxation was a cause?

Why was the structure of taxation changed so massively?

First, and most importantly, the government repeatedly offered income tax cuts to achieve wage restraint in the context of the trilateral wage agreements. This seemed sensible at the time as revenue was booming. However, over time, this approach narrowed the tax base and made it more fragile because the "booming" part of tax revenue turned out to be a transitional phenomenon.

Second, the Irish taxation system favours systematically, and more than in other EU countries, property and particularly home ownership. Ireland is one of very few countries where interest payments on mortgages can be deducted from income tax yet there is no property tax....

Third, the Irish tax system includes a large number of "tax expenditures" (tax allowances, reliefs and exemptions from income tax which – to some extent – reflect the income tax cuts mentioned above). According to the OECD,

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by 2005 the cost of “tax expenditures” had become larger than the remaining income tax receipts.... (Regling & Watson, p. 27)

A self-reinforcing spiral developed: higher prices and values caused increased speculative buying of housing and land; evaluators based their estimates on these higher prices; this increased the demand and collateral for bank lending, which in turn raised prices as more funding was provided. This development ended as housing prices reached their peak at the end of 2006 and construction in early 2007. (Nyberg, p. iii)

Whether income was a cause?

In 2007 incomes peaked at 114 per cent of the EU average. Just two years later, Irish incomes were once again below the EU 15 average and in 2010 are estimated to be 8 per cent below the average with only Italy, Spain, Portugal and Greece recording lower levels of income. (Wright, p. 16)

Wage settlements accelerated markedly from the late 90s, in absolute and in relative terms. The “trilateral” wage agreements continued but became less relevant as workers negotiated supplementary wage increases against the background of full employment and an overheating economy. Compensation per employee, which had grown more or less in line with the euro area average until 1996, increased at two to three times the euro area average from 1997 to 2008. In nominal terms, annual gross wages in Ireland in 2007 were the highest in the euro area except Luxembourg. Ireland had also the highest price level in the euro area according to Eurostat statistics. Competitiveness deteriorated significantly. (Regling & Watson, pp. 21-2)

Economic overheating, along with the Social Partnership Process, led to a major deterioration in competitiveness in the Private Sector and to very high Public Service wages, especially relative to international partners. (Wright, p. 25)

Whether fiscal policy was a cause?

For a long time, Ireland's overall fiscal policy was considered to be exemplary because the country achieved fiscal surpluses every year from the mid-1990s to 2006, including the creation of a Pension Reserve Fund to make budget surpluses politically more acceptable. (Regling & Watson, p. 24)

Then budgetary policy veered more toward spending money while revenues came in. In addition, the pattern of tax cuts left revenues increasingly fragile, since they were dependent on taxes driven by the property sector and by high consumer spending. Ireland was also unusual in having tax deductibility for mortgages, and significant and distortive subsidies for commercial real estate development, yet no property tax. (Regling & Watson, p. 5)

Voted expenditure grew, on average, by about 11.5 per cent a year between 1998 and 2008.... Between 2007 and 2009, total general government receipts fell by 21 per cent. While the yield on all tax heads fell, the declines in capital taxes (stamp duty, capital gains tax and capital acquisitions tax) were especially sharp. (Wright, p. 18)

Government spending doubled in real terms between 1995 and 2007, rising at an annual average rate of 6 per cent. With the economy growing at an even faster rate, this implied a generally falling or stable expenditure ratio of expenditure to GNP until 2003. But thereafter the ratio rose, especially after output growth began to slow in 2007.

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And, in a final twist, real expenditure rose by over 11 per cent in both 2007 and 2008, an unfortunate late burst of spending which boosted the underlying deficit at almost the worst possible time (*Honohan, p. 30*)

The ceiling on the income tax deductibility of mortgage interest for owner-occupiers was increased in 2000, 2003, 2007 and 2008. By 2006 Ireland was one of only four OECD countries which allowed income tax deductibility while not taxing imputed rental income or capital gains for owner-occupiers. Furthermore, no residential property tax existed (*Honohan, p. 31*)

The main reason for the sharp increase in the fiscal deficit in 2008-09 was the collapse in tax revenue. This was possible because the structure of tax revenue had changed dramatically from the 1990s to 2006-07. The composition of tax revenue had shifted gradually from stable sources of taxation, like personal income tax and VAT/excise taxes, to cyclical taxes, such as corporation tax, stamp duty and capital gains tax. The share of these cyclical taxes reached 30 percent of tax revenue in 2006; in the late 1980s it had amounted to only 8 per cent. The overall revenue-to-GDP ratio was more or less unchanged at around 35-37 percent from the 90s until 2007. (*Regling & Watson, p. 26*)

The main cause of the borrowing surge was the collapse in tax revenues in 2008-09 which appears to have been the most pronounced of virtually any country during the current downturn. Much of the reason for the revenue collapse lies in the systematic shift over the previous two decades away from stable and reliable sources such as personal income tax, VAT and excises towards cyclically sensitive taxes. Revenue became increasingly dependent on corporation tax, stamp duties and capital gains tax (in that order); the contribution of these taxes to total tax revenues rose steadily from about 8 per cent in 1987 to 30 per cent in 2006 before falling to 27 per cent in 2007 and just 20 per cent in 2008.... Had the tax structure been less cyclically sensitive, the fall in revenue in 2008 would have been much lower (*Honohan, pp. 28-9, Chart 2.8*).

[Another] factor[s] important to the crisis in Ireland was 'the degree to which adequate buffers were [not] built into national fiscal policies, after allowing for the transient nature of revenues from the financial boom'. (*Regling & Watson, p. 11*)

After some transitional arrangements, most of these incentives were abolished by 31 July 2008, after the expiration date of the schemes had earlier been extended on several occasions during 2000-08. (*Honohan, p. 31*)

Domestic policies did not act as a sufficient counterweight to the forces driving this unsustainable property bubble. Bank regulation and financial stability policy clearly failed to achieve their goals. Neither did fiscal policy constrain the boom. Indeed, the increased reliance on taxes that could only generate sufficient revenue in a boom, made public finances highly vulnerable to a downturn. (*Honohan, p. 20*)

Whether EMU was a cause?

Certain aspects of EMU membership certainly reinforced vulnerabilities in the economy. Short-term interest rates fell by two thirds from the early- and mid-90s to the period 2002-07. Long-term interest rates halved. Real interest

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rates were negative from 1999 to 2005 after having been strongly positive earlier. This contributed to the credit boom, the strong increase in household debt, the property bubble and the general overheating of the economy. The removal of exchange rate risk facilitated foreign funding, including for the growing current account deficits. This financing ease meant that Ireland's boom could continue for longer than without EMU membership, and the asset bubble could become bigger. However, it was clear in the second half of the 1990s that entering EMU would imply a permanent shift to a lower interest rate level which – naturally – was seen as advantageous. (*Regling & Watson*, p. 24)

During the years preceding the crisis, an important influence on banking developments was the continued increase in Ireland's integration with other European financial markets. Two changes in this area affected bank behaviour in Ireland particularly strongly:

- First, and more importantly, following euro adoption, there was a quantum change in the availability of cross-border bank funding without foreign exchange exposure. This clearly facilitated the lending boom in Ireland, while also meaning (on the very positive side) that large foreign exchange risks did not build up among end-borrowers of funds.
- Second, there was also an impact of foreign (especially UK-based) banks on competition for lending to the real estate sector.

Fiscal policies were pro-cyclical in most advanced economies in the years up to 2007, thus contributing to the build-up of internal imbalances in these economies and making them more vulnerable to a crisis. (*Regling & Watson*, p. 13)

Whether consensus was a cause?

For most of the past twenty years, the Irish economy was regarded as a model. Very few questioned this general consensus and those that did were ignored. The move from one of the poorest countries in the EU to one of the richest, in terms of annual income, fuelled expectations for increased spending towards levels in the rest of Europe. (*Wright*, p. 19)

Economic overheating, along with the Social Partnership Process, led to a major deterioration in competitiveness in the Private Sector and to very high Public Service wages, especially relative to international partners. (*Wright*, p. 25)

Warnings of a bubble

The Irish authorities had the data required to arouse suspicion about trends in the property and financial markets. The relaxed attitude of the authorities was therefore the result of either a failure to understand the data or not being able to evaluate and analyse the implications correctly. Both macroeconomic and banking data could, particularly when combined, have provided the authorities with an understanding of what was going on. The Financial Stability Reports (FSR) provided information on individual perceived risks but, in the Commission's view, the data should have raised greater suspicions by end-2005 or, at the latest, by 2006. (*Nyberg*, p. 91)

By the end of 2005, on a reasonable assessment, the authorities should have been sufficiently concerned about the emergence of a property bubble to consider aggressive action to deflate it: new house prices had increased by 40% since 2002; property-related lending in relation to GDP was double that of the UK and proportionate to population,

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house completions were six times higher in Ireland than in the UK.. 12% of the Irish working population was employed in construction and construction output accounted for 20% of Ireland's GDP. (*Nyberg, p. 60*)

Residential investment as a percentage of national output reached nearly 13 per cent in 2006, double its long-term average. (*Regling & Watson, p. 22*)

Real residential property prices jumped to almost four times their historic norm... The three-fold increase in average real property prices 1994 to 2006 was the highest in any advanced economy in recent times and, long before it peaked, looked unsustainable to most commentators (*Honohan, 2009 & p. 24*).

In absolute terms, over the period 2002 to 2008, domestic property-related lending increased by almost €200bn which represents 80% of all growth in credit. This raised the share of property-related lending from under 45% of total credit in December 2002 to over 60% in December 2008. (*Nyberg, p. 14*)

Total loans to customers grew by an average of 21.8% annually during the period. Property-related lending grew even faster and the fastest growth of all was in speculative C&P lending which grew by an average of 56.5% each year. (*Nyberg, p. 16*)

The covered banks' exposure to C&P lending had grown to over 48% of GDP by 2008, up from 11% in 2002. (*Nyberg, p. 17*)

At end-2003, net indebtedness of Irish banks to the rest of the world was just 10 per cent of GDP; by early 2008 borrowing, mainly for property, had jumped to over 60 per cent of GDP. Moreover, the share of bank assets in property-related lending grew from less than 40 per cent before 2002 to over 60 per cent by 2006. (*Honohan, p. 26*)

The covered banks accounted for over 65% of the overall growth in property-related lending in Ireland over the period 2002 to 2007. Their domestic property lending to Irish residents grew by 262% to €168bn by December 2007. (*Nyberg, p. 15*)

The 2007 FSR included an analysis of commercial property and noted a growth in price-earnings ratios that implied overvaluation. (*PAC, p. 94*)

The current difficulties of the Irish banks – whether in terms of liquidity or solvency – are directly attributable to their over-lending for land and property investment, much of it through heavy short-term wholesale foreign borrowing. (*Honohan, p. 22*)

Formulation and reaction to crisis simulation exercises

Risk simulation

While the DoF identified various risks to the economy and to its budgetary forecasts, no single comprehensive analysis integrating all of these risks (including risks emanating from the financial sector) and assessing their implications for the economy into the medium-term was carried out. (Nyberg, p. 69)

A paper entitled *Crisis Resolution Options* was discussed by the DSG in mid-2008. It reviewed the possible procedures and potential pitfalls involved in dealing with a troubled bank or building society. Two main crisis options were considered, namely assisted private sector acquisition and nationalisation (other possibilities briefly considered in an earlier draft included use of ELA, alternative mechanisms for providing liquidity, for example by investing (against collateral) some of the liquid assets of the NTMA, and a blanket guarantee). However, the paper offered little detail about implementation of the various options including that of the issuance of a guarantee (for example, it did not address the question of possible inclusion of subordinated debt. (Honohan, p. 117)

The DoF prepared a scoping paper on financial stability issues in early 2008. It examined three cases: (i) an institution that is illiquid but solvent; (ii) an institution that is insolvent or is approaching insolvency; and (iii) a scenario in which it is unclear whether the institution is illiquid or insolvent. A number of possible solutions were identified for each of these scenarios. The paper discussed the circumstances under which ELA could be available to an insolvent institution (i.e. only after a State Guarantee had been provided), as well as nationalisation; it concluded that both a guarantee and nationalisation would require new legislation. An internal departmental presentation in February 2008 indicated that “as a matter of public policy, to protect the interests of taxpayers any requirement to provide an opened/ legally binding State guarantee which would expose the Exchequer to the risk of very significant costs [is] not regarded as part of the toolkit for successful crisis management and resolution”. However, in a later presentation in April 2008, while this view was repeated, it was also noted that “there are circumstances where such guarantees may be unavoidable to maintain confidence in the overall financial system. (Nyberg, pp. 75-6)

AIB, BoI and Anglo all paid dividends during 2008, and a DSG minute dated 8 July 2008 notes a report by the Financial Regulator that a “line-by-line” examination by a “major bank” of its loan book showed profitability even using a “worst-case” scenario. (PAC, p. 129)

The underlying models were not reliable when basic market parameters changed context; and in addition, scenario construction, which is at the heart of successful risk analysis, was insufficiently imaginative in exploring macro-financial vulnerabilities and linkages. (Regling & Watson, p. 20)

If the CB had had greater concerns there was nothing preventing them from confidentially voicing these concerns to the Government while keeping its public messages benign. However, the Commission has found no evidence that this was done. The Commission notes that the CB did not choose to confidentially study worst-case contingency scenarios. (Nyberg, p. 68)

Role, responsibilities and objectives of the DSG

Context for the DGS's work

The PAC summarised the causes, as enunciated in the various reports, as follows:

- bank assets were concentrated in property, particularly commercial property;
- lending and credit policies were relaxed and frequently ignored in the interests of growth;
- risks relating to high loan-to-deposit ratios and the use of wholesale funding were poorly understood;
- risk management was ineffective; and
- contrarian views were inhibited by competitive pressures and consensus views. (*PAC, p. 32*)

Regling & Watson identified four demonstrable warnings of the impending crisis as follows:

1. First, **lending trends** in the Irish banking sector – especially from 2003 onwards – feature a pace of expansion, and a rise in asset and funding risks, that should have rung alarm bells. (*Regling & Watson, p. 29*)
2. The second, and analytically even clearer, hallmark of mounting risks lay in the **asset concentration of some major lending institutions**. This was a threefold concentration. It featured loans to the property sector in general; loans to commercial property specifically; and within this latter group, development loans to interests associated with a limited number of key developers of commercial property. In this respect, Ireland stands out. (*Regling & Watson, p. 31*)
3. The **concentration of risks** in lending was a feature that made the banking system particularly vulnerable. Cycles in credit to commercial real estate are prone to particularly wide swings; and in the upswing of the cycle in Ireland, there is wide agreement that property development was well ahead of trends that fundamentals could justify. This put bank capital heavily at risk in some cases. ... Funding exposure is perhaps best illustrated by loan to deposit ratios (Charts 11 and 12). A ratio of above 200% for the system as a whole was higher than other comparable euro area economies, leaving a large hole to be filled with debt securities and interbank borrowing. (*Regling & Watson, pp. 32-3*)
4. The period from 2003 to 2006 saw **wholesale borrowing** by Ireland in the euro area markets grow rapidly as a source of funding, reaching, in Ireland, about 39% of the combined loan books for the six financial institutions at end-2006. The growth in short term borrowing was even more rapid, with securities of one year remaining maturity or less amounting to €41bn at end 2006 for the two largest banks, up from €11.1bn at end 2003. Rolling over such borrowings was predicated on the continuation of benign wholesale markets. (*Regling & Watson, p. 33*)

Work of the DSG

The DSG exchanged information about financial markets and regulatory issues, developed procedures and legislation for managing financial stability crises, and participated in crisis simulation exercises. A note of a DSG meeting on 21 September 2007 includes an observation about the reliance of European banks on wholesale funding, adding “need to do more research on that”. (*PAC, p. 127*)

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The DoF saw itself as preparing legislation to be implemented by the other authorities, but appears to have avoided addressing other financial market issues unless brought to the table by the FR or the CB (for instance, Credit Union issues during the Period). This apparently was due to their legally independent status. The Commission could find no evidence that the DoF formally tried to influence the FR in its work. The DoF also did not make any efforts to strengthen its own financial market expertise despite crisis management exercises in the EU having shown a need for it among finance ministries. (Nyberg, p. 93)

Had the DoF taken a greater interest in financial market issues early on, preparations for dealing with the financial crisis would have been more comprehensive. It is well documented that the DoF consistently, though not forcefully enough, supported a less expansive fiscal policy, particularly regarding property market incentives. It also appears that worries about the developing financial situation were expressed internally from time to time by some DoF staff. However, nothing came of this as the CB and FR were seen as responsible for financial stability. (Nyberg, p. 93)

Being conscious and supportive of the independence of both the CB and the FR, the DoF provided very little comment or input to this process, nor did it assess how they fulfilled their duties until very late in the Period. Neither the CB nor the DoF seem to have considered the implications of a possible interruption in the flow of foreign funding. If such a scenario had been considered, the link between such funding, property market developments and bank solvency could perhaps have been uncovered. (Nyberg, p. viii)

Black Book

The Government had earlier concluded that it could not permit any Irish bank to fail (which the Commission understands was also the advice from the ECB), given the potentially very serious adverse effects on confidence in the banking system in Ireland and elsewhere. (Nyberg, p. 78)

The authorities began to explore contingency arrangements from mid-2007 onwards (in the wake of the Northern Rock crisis in the UK... Important initiatives taken during this period included the establishment, in line with EU guidance, of the Domestic Standing Group (DSG), which involved, for the first time, a specific structure for ongoing cooperation between the DoF, the CB and the FR. The National Treasury Management Agency (NTMA) also attended several DSG meetings. In addition, especially from mid-2008 onwards, many other meetings and informal interactions occurred between these institutions. A liquidity monitoring group was set up within the CB which led to a more systematic evaluation of potential problems the banks might face. In parallel, arrangements were made to ensure that banks had available the maximum eligible collateral to access refinancing by the ECB and that the mechanisms to allow possible emergency lending assistance (ELA) from the CB were in place. Finally, some “crisis management” exercises were held (one involving an EU-wide exercise) using the “Black Book” crisis management guide as background. However, in the actual crisis no use was made of the Black Book procedures. In early 2008, CB staff concerned with financial stability matters produced a draft document which outlined, in fairly general terms, the options available if an individual institution were to encounter difficulties (the possibility of a systemic crisis was not considered).

The investigations to date found that the 'black book' was, in practice, found to be cumbersome and was not relied upon. Experts consulted by the Committee suggest that this is in line with international experience that the more elaborate a plan, the more likely it is to be ignored in an actual crisis. On the other hand, an effective integrated command system (ICS) has been proven to be particularly helpful where crises require a response from a network of organisations and where there is potential for confusion as to lines of command. Given that the crisis-management structure envisaged by the DSG was not implemented, the Committee is of the opinion that there are outstanding questions about who ultimately made the decision to issue the guarantee, on the advice of whom and on the bases of what information. (*PAC, p. 151*)

The CB did not choose to confidentially study worst-case contingency scenarios. (*Nyberg, p. 68*)

Adequacy of the DSG process, including consideration of the bank resolution legislation

General actions

Among the actions taken to enhance preparedness were: (i) enhanced cooperation between the CBFSAI and the Department of Finance, via the Domestic Standing Group (DSG) including a crisis simulation exercise; (ii) the preparation of a crisis management manual, including specific institutional issues that arose in light of the Northern Rock collapse and preparation for the possible use of emergency liquidity assistance (ELA); (iii) enhanced monitoring of liquidity flows; and (iv) advance consideration of some practical issues relating to crisis resolution options. These are reviewed in turn. (*Honohan, p. 114*)

The DSG reviewed options for resolving potential financial crises in June 2008. The main options considered were the assisted acquisition of a distressed bank by a private (i.e. non-State) buyer and nationalisation. Other options included ELA, investment by the NTMA, and blanket guarantees. The review did not detail how these were to be implemented and recommended that legislation for nationalisation and bank resolution be investigated. If a bank were to be nationalised, it was considered likely that a State guarantee would also be required (*Honohan 8.14*). Mr Kevin Cardiff, who in 2008 was Assistant Secretary-General with responsibility for banking, told the Committee in 2010 that the group's general view on these issues was informed by the Economic and Financial Affairs Council (ECOFIN), which had stated that no systemic bank should be allowed to fail (*PAC 6 May 2010 at p. 57, and PAC, p. 128*).

Both Nyberg and Honohan note that much time was taken up by matters related to Anglo's share price and the effect of the Quinn/Anglo contracts for difference (CFD) situation. This prevented sufficient attention being paid to the mounting pressures on the banks, and actions - such as raising or conserving capital - that might have mitigated the risks they faced (*Nyberg 4.6.9, Honohan 8.15*).

As the discussions regarding procedures for crisis containment started to unfold, early on a clear consensus view emerged that **no Irish bank should be allowed to fail**, in the sense of having to close its doors and not repaying depositors and other lenders. This strong view departed from the textbook view that only systemically important

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institutions should be candidates for such protective treatment. (*Honohan, p. 119*)

Legislation

One specific issue highlighted during this period concerned the possibility of introducing a special resolution regime for banks. Existing company law provisions were unsuitable for dealing with financial institutions in difficulties. Following preparation of a background paper in June, the possibility of implementing such legislation was discussed within the Domestic Standing Group. It was concluded that the legislation would be complex and would take considerable time to prepare. (*Nyberg, p. 76*)

One important initiative was, however, pursued vigorously in the pre-crisis period, namely, the preparation (on a highly confidential basis) of draft contingency legislation that would (i) enable nationalisation of a financial institution;¹³⁴ and (ii) provide for the issuance of a guarantee by the Government. (*PAC, p. 129*)

A General Scheme was prepared for draft legislation (known as the “Heads of a Bill”) providing for nationalisation of a bank or building society and issuance of a guarantee by the Minister. The Heads refer only to a general guarantee of the borrowings and liabilities of the affected institution and do not distinguish between different classes of debts such as senior or subordinated bondholders. They do however refer to the possibility of a guarantee under another proposed Bill. (*PAC, p. 129*)

Role, responsibilities and objectives of the DSG

Pre-Liquidity Group - Macro Stress Tests

Despite the overall resource constraints present, it would have clearly been desirable for more intensive efforts to have been devoted earlier to analysing the possible evolution of commercial property prices. This is especially the case since evidence from elsewhere suggests that the bursting of a property bubble in this sector can have a considerably more severe adverse financial impact than in the case of the residential market. Also, in this context, priority would probably need to have been given to obtaining - via the Financial Regulator - more comprehensive information from the financial institutions regarding property related lending, including cross exposures as well as exposures associated with speculative equity investments; problems in this area appear to have continued unresolved throughout the period reviewed. (*Honohan, p. 85*)

Statistical tools to capture the full impact of asset bubbles on tax revenue are not well developed, otherwise it would have become clearer much earlier that the structural, underlying fiscal balance was much less favourable than assumed at the time. (*Regling & Watson, p. 25*)

Macro – that is, system-wide – stress-tests in financial stability reports allegedly showed most banks to have sufficient buffers against extreme shocks; but typically these tests did not combine funding and asset market shocks. With the benefit of hindsight, moreover, it is clear that these, like the micro stress-tests of individual institutions, were much too mild. (*Regling & Watson, p. 19*)

The underlying models were not reliable when basic market parameters changed context; and in addition, scenario construction, which is at the heart of successful risk analysis, was insufficiently imaginative in exploring macro-

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financial vulnerabilities and linkages. (*Regling & Watson, p. 20*)

A faster appreciation of the reality - and the associated looming costs - underlying the above elements would have allowed the authorities to take earlier, more decisive and more credible action. From this point of view it could have been useful to use specialists in restructuring to assess the financial position of the covered banks. The solvency position of Irish institutions could then have been strengthened with significant capital increases well before the renewed onset of the liquidity problems, and non-systemic insolvent institutions could in a “normal” way have had their doors closed earlier and been wound down over time. (*Nyberg, pp 85-6*)

Lending context

In a growth environment, readily available liquidity and perceived/expected demand for property can artificially inflate its value and create additional equity above existing loans. When the perceived demand and liquidity disappear, so does the supposed equity. Banks lent significant amounts to the Irish property market against apparent equity with the expected source of repayment being anticipated rental uplifts (in the case of property investment) or, in many cases, the refinance or sale of the asset. (*Nyberg, p. 36*)

Funding Gap

As the covered banks’ domestic lending grew so substantially, retail and corporate deposits could not provide sufficient funding. ... The covered banks’ requirement for non-deposit funding increased almost fivefold over the period -2002 to 2008] from €26bn to €129bn and grew at a particularly high rate from 2004 to 2007. The rest of the banks had a similar though generally smaller funding gap. This funding gap was financed by wholesale market funding and largely represented increasing foreign borrowing by the banks. This foreign debt was used largely to fund the domestic property market. (*Nyberg. p. 20*)

Liquidity Group

Macro-economic data signalling the emergence of the two key risks – growing dependence on foreign funding and the concentration of bank lending in the property sector – did not appear to have caused acute concern [in the CB]. At least at policy level, the CB seems not to have sufficiently appreciated the possibility that, while each bank was following a strategy that made sense, in the aggregate, when followed by all banks, this strategy could have serious consequences for overall financial stability. This was a classic macroeconomic fallacy (*Nyberg, p. 92*)

From late summer 2007, the CBFSAI had been in increasingly crisis mode as it sought to prepare for the consequences of a possible looming liquidity squeeze for some or all of the Irish controlled banks. ... Almost all of the efforts ... were focussed on the important task of improving the contingent access of the banks to liquidity. (*Honohan, p.13*)

A Liquidity Group chaired by the Deputy Director General of the CB was established in early 2008 to obtain and disseminate information on liquidity developments from the main credit institutions and to identify any potential problems at an early stage.... While this exercise proved to be a valuable tool in helping to establish a ‘real time’ picture of liquidity developments during the turmoil, a comprehensive, daily picture of the actual liquidity flows had not been put in place before early 2009. During 2008, the liquidity situation deteriorated, as reflected in the unprecedented recourse to financing from the European Central Bank which rose from a monthly average of around

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€6 billion in September 2007 to €20 billion in September 2008 (*Honohan, pp.116-7*)

While considerable effort was thus devoted to preparing for a liquidity crisis, this period was also noteworthy for the unravelling of the Quinn-Anglo CFD affair, which was not ultimately resolved in a satisfactory manner. This appears to have represented a major preoccupation for the Authority at a crucial time. (*Honohan, p. 118*)

As late as September 29 itself (and indeed for quite some time afterwards), the position of the CB and the FR seems to have been that Irish banks all remained solvent in the sense that they had to date met all prudential ratios, and that there was therefore little immediate cause for concern. The possibility that they might experience catastrophic losses in asset values into the future does not appear to have been given serious consideration even from a contingency policy point of view. (*Nyberg, p. 78*)

The stress tests that were conducted followed international practice and the standard qualifications as to their interpretation were presented. However, it is clear that the shocks involved, while thought to be extreme at the time, did not in fact capture the scale of what could and did happen. This was true of both the adverse international and domestic macro scenarios and the assumed deterioration in the quality of banks' loan portfolios. (*Honohan, pp 94*)

The stress tests showed the banks to be resilient to economic shocks based on the assumptions used. However, the more severe shocks were discounted as the banks were confident that a soft landing was likely outcome and that their loan portfolios and funding sources were sufficiently diversified. (*Nyberg, p. 45*)

Apart from the fact that the scenario was insufficiently severe, the capacity of the banks to undertake the exercise differed greatly; indeed none of them had reliable models, tested and calibrated on Irish data, which could credibly predict loan losses under varying scenarios. (*Honohan, p. 11*)

The presentation of aggregate weighted average results, in particular those of the "top down" approach, masked differential impacts across individual institutions. (*Honohan, p. 88*)

The absence of substantial analytical work by the CB – even on an internal, confidential basis – to consider the implications of an alternative, much less favourable outcome, is striking. (*Nyberg, p. 87*)

Implicitly it seems to have been assumed that lenders had protected themselves against loan losses through sufficiently low loan-to-value ratios (sufficiently high co-financing), or assurance of other sources of income to service loans. However, only the CBFSAI could have had access to the information that could confirm the true situation, whether through regulatory inspections or the bottom-up stress test exercises. But the approach used by the Financial Regulator did not yield the information needed and the implementation of the stress tests did not seek to verify or assess such aspects as loan-to-value ratios for development property lending. In the event, the implicit assumption that either the banks, or the Financial Regulator has ensured sufficient buffers against whatever fall in property prices might occur proved to be misplaced. (*Honohan, pp 94-5*)

The fact that loans to overlapping subgroups of the same set of property developers accounted for such a high

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fraction of credit outstanding from most of the credit institutions implied a systemic risk not captured in risk assessments carried out for one bank at a time. (*Honohan, p. 110*)

Trust in a soft landing was consistent and, though not very well founded, continued up until and including the crisis management phase of the Period. (*Nyberg, p. vii*)

Lending Caps

There appears to have been little serious thought given to the idea of setting binding or even non-binding limitations on credit extended specifically to the property sectors which had been expanding at truly unprecedented rates. Sectoral limits had in earlier years prior to the adoption of the euro formed a significant part of the arsenal of instruments used by the Central Bank. (*Honohan, p. 105*)

Alternatively, a ceiling could have been placed on the rate of growth of credit extended by one or more institutions, especially those experiencing dangerously high growth. This would have been a major departure from the moral suasion approach to enforcement and would not sit comfortably with market-oriented policy in normal times. (*Honohan, p. 105*)

Aside from ELA, although a large amount of resources had been devoted to preparation of the crisis management manual, it was not employed to any significant extent during the actual crisis. This was due to the fact that the procedures outlined were excessively cumbersome, and sought to involve too many officials of the Central Bank and Financial Regulator at a time when rapid decision making was at a premium. (*Honohan, p. 116*)

Role of advisors such as Merrill Lynch in analysis crisis management options

PwC

Addressing the Committee of Public Accounts in 2010 Mr Cardiff indicated that his main source of information on the state of the banks was the Financial Regulator. He conceded that the fact that it had been found necessary to send in PwC to get an accurate picture suggested that the Financial Regulator did not have entirely accurate information. (*PAC, p. 133*)

Asked about the conclusions he drew from Anglo's up-beat presentation on 18 September and its state four days later, Mr Cardiff told the Committee of Public Accounts that, while solvency was always a consideration, the focus of concerns was on liquidity because PwC's report had indicated that Anglo's loan book, while not comprising assets that would give it quick access to liquidity, showed only 3% impairment. This reflected accounting standards which prevented the bank from making provisions for impairment before the corresponding debts actually fell due. (*PAC, pp 130-1*)

This letter [from PwC on the Guarantee] provided assurances to Government that although some losses were likely, the problem remained one of liquidity rather than solvency, while the need for the increased capital was ascribed to market expectations. The DoF, in briefing the Minister, did not diverge from this view but added that the perceived weaknesses of Irish banks could threaten their ability to fund themselves. (*Nyberg, p. 82*)

Notwithstanding the benign view generally taken by the Authorities of the PwC initial assessment it has been

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argued – correctly, in the Commission’s view – that the nature, scale and concentration of the exposures now listed should have aroused more heightened and widespread concerns that institutions were likely to face solvency difficulties. (*Nyberg, p. 85*)

Merrill Lynch

Responding to public disquiet, on 20 September 2008 the Minister increased the limits under the Deposit Guarantee Scheme to the lesser of 100% of deposits or €100,000. This stabilised retail deposits in the banks, but wholesale deposits continued to be withdrawn. The NTMA retained Merrill Lynch to advise on how to manage the crisis. (*PAC, p. 130*)

On 26 September [2008] Merrill Lynch presented to the Minister on the options discussed the previous day. The options outlined included nationalisation and a “Secured Lending Scheme” (SLS), under which the Central Bank would issue high-grade securities to the banks in return for collateral from their loan books; this would give the banks greater access to liquidity but would place the risk of the banks’ loans on the Central Bank’s balance sheet. Concerns about those risks, the Central Bank’s relatively low cash buffer, and EU restrictions on State aids militated against this proposal (*Honohan 8.22 and PAC, p. 131*).

Another option was to use ELA to provide short-term liquidity. This too raised questions of the risk assumed by the Central Bank and the effect on its limited cash buffers. Given ELA’s “last resort” nature, its use would cause reputational damage to Irish banks generally that could bring them all down (*Honohan 8.23, PAC, pp. 131-2*).

Other options presented to the meeting included guarantees, nationalisation, and the “bad bank approach”. In relation to guarantees Merrill Lynch advised that depositors and senior bondholders should be covered, and possibly dated subordinated bondholders. A guarantee is described in the presentation as the “best/most decisive/most impactful” measure from the market perspective, but Merrill Lynch advised that a blanket guarantee for all banks could be a mistake and would affect Ireland’s credit rating and prolong the survival of weak institutions. Minutes taken at the meeting emphasise the importance of credibility. The question of including dated subordinated debt was discussed. Undated subordinated debt holders are not mentioned in the Department’s note of the meeting. (*PAC, p. 132*)

The potential for a major pay-out from the guarantee was not considered large, though no attempt was made at quantification. There were arguments against a blanket guarantee, including one made by the Department of Finance’s advisors Merrill Lynch who observed that the assumption of such a large contingent liability would have an adverse effect on the borrowing costs for the State. And there is a moral hazard involved in any such guarantee, though this argument does not appear to have been made. Still, given the perceived lack of a solvency problem at Anglo (or the other banks) on balance a guarantee seems to have been the best approach, not least because no other clear and effective medium-term solution appeared available. This is not to underestimate the huge cost to the bailout which has ended up in excess of 15 per cent of GDP. (*Honohan, pp. 132-3*)

On Monday 29 September there was a dramatic fall in Anglo’s share price and continuing deposit withdrawals. That afternoon, the Chairmen and CEOs of AIB and BoI requested a meeting with the Taoiseach and Minister for

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Finance to discuss the impending collapse of Anglo and how it might affect their banks. A series of meetings followed involving the Taoiseach, the Minister, Merrill Lynch, CBFSAI and the Department. According to Honohan, AIB and BoI sought a general guarantee (including subordinated debt) and the nationalisation of Anglo and possibly INBS so as to remove their negative reputations and reduce the other banks' borrowing difficulties (*Honohan 8.30 and PAC, p. 132*).

Mr Cardiff was unable to tell the Committee whether AIB and BoI had brought documents or financial statements, and he could not produce a minute of their meeting with the Taoiseach and Minister, even though officials were present. (*PAC, p. 132*)

No contemporaneous records are available of the decision to recommend the adoption by the Government of the guarantee, and the Government's decision is subject to Cabinet confidentiality. However, Mr Cardiff stressed Merrill Lynch's observation that "the guarantee was the quickest means of making the greatest impact, although certain risks were associated with it". (*PAC, p. 134*)

Against this background, work intensified on recapitalisation options with the extensive input of Merrill Lynch. On November 28, the Minister announced that, on the basis of a report that analysed the loan books of the major financial institutions, their capital levels would remain within regulatory requirements in the period through to 2011 even under certain stress scenarios. However, in certain circumstances it would be appropriate for the State "to consider supplementing private investment with State participation". Following a negative market reaction to the release of Anglo's end year results, on December 14 the Government announced a recapitalisation programme of up to €10bn. However, the positive impact of this decision was undermined by the emergence of the "loans to Directors" issue at Anglo which led to the resignations on December 18 and 19 of the Chairman and CEO of Anglo respectively. On December 21, announcements were made regarding the capital injection of €1.5bn into Anglo and €2bn each into both Bank of Ireland (BoI) and Allied Irish Bank (AIB). (*Nyberg, p. 84*)

Liquidity v Solvency

Wholesale borrowing

During the years preceding the crisis, an important influence on banking developments was the continued increase in Ireland's integration with other European financial markets. Two changes in this area affected bank behaviour in Ireland particularly strongly:

- First, and more importantly, following euro adoption, there was a quantum change in the availability of cross-border bank funding without foreign exchange exposure. This clearly facilitated the lending boom in Ireland, while also meaning (on the very positive side) that large foreign exchange risks did not build up among end-borrowers of funds.
- Second, there was also an impact of foreign (especially UK-based) banks on competition for lending to the real estate sector.

Fiscal policies were pro-cyclical in most advanced economies in the years up to 2007, thus contributing to the build-up of internal imbalances in these economies and making them more vulnerable to a crisis. (*Regling & Watson, p. 13*)

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Funding Gap

As the covered banks' domestic lending grew so substantially, retail and corporate deposits could not provide sufficient funding. ... The covered banks' requirement for non-deposit funding increased almost fivefold over the period -2002 to 2008] from €26bn to €129bn and grew at a particularly high rate from 2004 to 2007. The rest of the banks had a similar though generally smaller funding gap. This funding gap was financed by wholesale market funding and largely represented increasing foreign borrowing by the banks. This foreign debt was used largely to fund the domestic property market. *(Nyberg, p. 20)*

Aggregate capital growth

The aggregate capital resources (including shareholder funds and subordinated liabilities) of the covered banks grew from almost €18bn in 2000 to circa €47bn at the peak in 2007. Though the covered banks continued to meet their regulatory requirements in relation to capital ratios, the composition of this capital changed materially. The proportion of shareholder equity in the covered banks' capital decreased significantly, with the balance being made up by subordinated loan capital. *(Nyberg, p. 41)*

The relatively greater losses seen in Ireland [than in the EU and UK] may thus be seen as a consequence of somewhat greater abandon in accessing wholesale funding and in lending to domestic property than in other countries. Thus, there is a difference in degree rather than in concept. *(Nyberg, p. 88)*

Liquidity issues

From mid-2007 onwards, cooperation improved between the key institutions involved and some important preparatory crisis management work was undertaken. However, the view that the only relevant problem was a threat to the liquidity position of the banks remained unchallenged throughout. There appears to have been no fears and, at most, a modest discussion on possible underlying acute solvency problems. This is true of the banks themselves as well as of the authorities. *(Nyberg, p. 93)*

On 5 September 2008 Reuters alleged that INBS was in talks with lenders to avoid insolvency. Although retracted, pressure grew on banks as both share prices and access to funding declined. Prompted by these concerns, the Department commissioned Morgan Stanley to review ILP, Pricewaterhouse Cooper (PwC) to review Anglo and Goldman Sachs to review INBS. *(PAC, p. 129)*

On 22 September 2008 Anglo requested liquidity assistance of €7 billion from the Central Bank. The DSG reviewed available liquid reserves, which came to approximately €18 billion. On the same day reports from the consultants' reviews of ILP, Anglo and INBS were received. ILP and INBS were reported to be vulnerable to loss of liquidity within weeks, but could survive with assistance. Anglo was on the verge of running out of cash in days. *(PAC, pp. 130-1)*

Inspections

Supervision needs to be based on a deeper analysis of the links between risks in different types of asset and liability: these include the legal links between connected borrowers; the economic links between classes of assets that may deteriorate sharply at the same time; and the risk that asset problems may in turn trigger funding shortfalls. A credit register ("centrale des risques"), following the model of some other EU countries, could be one important tool

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in this connection. Financial stability analysis must be more integrated into supervision. It needs to capture liquidity as well as solvency risks. (PAC, p. 80)

They were not the focus of any systematic checks, either desktop or on inspection; and, unlike the FR's principles for the protection of consumers, they were never incorporated into a unitary Code. (Honohan, p. 46)

The number and type of on-site inspections carried out by the Financial Regulator was determined by financial institutions' risk ratings. In his 2007 Special Report the CAG found that the number of credit institution inspections fell significantly below target in 2005. He recommended that this be addressed along with the risk rating system in the report subsequently carried out by Mazars. (PAC, p. 76)

Inspectors noted very serious failures of governance such as rapid balance sheet growth, regular breaches of credit policies and rising LTV ratios, excessive reliance on personal guarantees, grossly inadequate appraisals of major loan applications, and failure to analyse loans in terms of their effect on the entire bank rather than on their own individual merits (Honohan 5.22-23). Inspection reports of the Financial Regulator on Anglo in 2004 and 2007 both identified serious prudential deficiencies (Nyberg 4.35). However, the severity of these was not judged to be high priority (Honohan 5.29).

Liquidity v Solvency

Liquidity (as opposed to solvency) supervision had been off the core Basel agenda for decades; and few regulators, if any, performed stress tests that combined asset market with funding shocks. In the euro area, financial integration and interdependency were goals of policy, and the side-effects on vulnerability were not strongly emphasized. (Regling & Watson, p. 18)

A faster appreciation of the reality - and the associated looming costs - underlying the above elements would have allowed the authorities to take earlier, more decisive and more credible action. From this point of view it could have been useful to use specialists in restructuring to assess the financial position of the covered banks. The solvency position of Irish institutions could then have been strengthened with significant capital increases well before the renewed onset of the liquidity problems, and non-systemic insolvent institutions could in a "normal" way have had their doors closed earlier and been wound down over time. (Nyberg, pp 85-6)

Following the Government's issue of the guarantee on 30 September 2008, it intensified its scrutiny of the covered banks to establish the extent of its contingent liability. PwC examined banks' loan books to get a clearer picture of their liquidity, while Merrill Lynch investigated the adequacy of capital. The preliminary results announced in November 2008 indicated that liquidity, rather than solvency, was the main issue of concern, though stress tests indicated that additional capital may be required to satisfy market expectations. (PAC, p. 137)

Notwithstanding the benign view generally taken by the Authorities of the PwC initial assessment it has been argued – correctly, in the Commission's view – that the nature, scale and concentration of the exposures now listed should have aroused more heightened and widespread concerns that institutions were likely to face solvency difficulties. (Nyberg, p. 85)

C3 - Crisis: Appropriateness and Effectiveness of DoF actions & policies

Appraisal of conditions prior to increasing the Deposit Guarantee Scheme

Outstanding questions

The Department of Finance papers that were provided to the Committee give an unclear and incomplete picture of how events unfolded. There are many questions about what transpired in the period leading up to and on 29 September 2008 (the night of the guarantee). Some of the issues identified by the Committee that require further examination include:

- What was the precise sequence of events in the period of weeks leading up to the guarantee?
- To what extent was there an adequate evaluation of alternatives to the bank guarantee carried out by Government?
- Was the guarantee the optimal policy choice given the alternatives available?
- To what extent was the scope of the guarantee the optimal policy decision given the other options available to the Government?
- What role, if any, was played by the Cabinet in the run up to the events of the night of 29 September 2008?
- To what extent do written records exist of the events leading up to the guarantee, and the guarantee itself?
- Who were the external advisors (formal and informal) during the crisis management period and what were their roles? (*PAC, p. 17*)

Information supporting liquidity and risks assessments

The discussions for alternative measures before and on September 29, 2008, were conducted on the basis of very deficient information. The authorities were apparently convinced that bank solvency issues were not pressing or significant, as were the banks themselves, and that it therefore would be possible to resolve the acute liquidity issue. Furthermore, the liquidity problems appear to have been seen as temporary only and related mainly to international developments. If more relevant information on and analysis of the underlying position of some of the banks had been available, discussions and policy recommendations may have been very different. (*Nyberg, p. 93*)

The potential for a major pay-out from the guarantee was not considered large, though no attempt was made at quantification. There were arguments against a blanket guarantee, including one made by the Department of Finance's advisors Merrill Lynch who observed that the assumption of such a large contingent liability would have an adverse effect on the borrowing costs for the State. And there is a moral hazard involved in any such guarantee, though this argument does not appear to have been made. Still, given the perceived lack of a solvency problem at Anglo (or the other banks) on balance a guarantee seems to have been the best approach, not least because no other clear and effective medium-term solution appeared available. This is not to underestimate the huge cost to the bailout which has ended up in excess of 15 per cent of GDP. (*Honohan, pp. 132-3*)

The Government's limited insight into the large risks it was assuming cannot be excused. Had there been a proper understanding of the banks' situations in the years before the crisis, remedial action might have been taken, though given the depth of the crisis and the extent of the banks' exposure to property, even that is not certain (*Nyberg 4.7.11 –12, and PAC, p. 135*)

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All the possible policy alternatives were at this time fraught with risk and the time for decisions was very short. Increasingly, the main issue at hand was seen as ensuring market financing for the banks at the beginning of the next day; making sure that “Ireland was open for business” in the morning. There is no evidence that the CB or the FR had substantial concerns regarding an emerging solvency risk among the banks. Initially the Guarantee was a success. (*Nyberg, p. 80*)

The absence of sufficient information on the underlying quality of the banks’ balance sheets is likely to have had a significant impact on the alternatives that were considered reasonable on September 29, 2008. (*Nyberg, p. ix*)

Appropriateness of the Bank Guarantee Decision

Scope of Guarantee

Responding to public disquiet, on 20 September 2008 the Minister increased the limits under the Deposit Guarantee Scheme to the lesser of 100% of deposits or €100,000. This stabilised retail deposits in the banks, but wholesale deposits continued to be withdrawn. The NTMA retained Merrill Lynch to advise on how to manage the crisis. (*PAC, p. 130*)

The guarantee extended to all the deposits, covered bonds, senior debt and dated subordinate debt of AIB, BoI, Anglo, ILP, INBS and EBS. The covered banks were to fund the guarantee by a payment based on the estimated stress on the State’s creditworthiness. (*PAC, p. 134*)

After the decision to issue the guarantee, AIB and BoI were asked to provide Anglo with immediate short-term liquidity. The two banks agreed to provide a total of €5 billion for a matter of days, subject to Government guarantee. The Central Bank also agreed to allow Anglo a €3 billion liquidity facility, which, following the inflow of funds consequent to the guarantee, Anglo did not draw upon (*Honohan 8.31 –8.32, PAC, p. 134*).

No contemporaneous records are available of the decision to recommend the adoption by the Government of the guarantee, and the Government’s decision is subject to Cabinet confidentiality. However, Mr Cardiff stressed Merrill Lynch’s observation that “the guarantee was the quickest means of making the greatest impact, although certain risks were associated with it”. (*PAC, p. 134*)

Guarantee – options assessment

It could have been useful to consider using other available financing for a few days, using the time to assess ways of limiting the Guarantee and to urgently scrutinise the state of some banks. (*Nyberg, p. ix*)

If accurate information on banks’ exposures had been available at the time it seems quite likely to the Commission that a more limited guarantee combined with a State take-over of at least one bank might have been more seriously contemplated. (*Nyberg, p. ix*)

This letter [from PwC] provided assurances to Government that although some losses were likely, the problem

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remained one of liquidity rather than solvency, while the need for the increased capital was ascribed to market expectations. The DoF, in briefing the Minister, did not diverge from this view but added that the perceived weaknesses of Irish banks could threaten their ability to fund themselves. (*Nyberg, p. 82*)

Given the information provided, the Commission understands the Government's decision to provide a broad guarantee for the banks; if no major solvency problems were expected the Guarantee would not have to be called upon. However, given the size of the amounts involved as well as the domestic and global uncertainties, it could have been useful to access available temporary funding to gain time to examine more thoroughly the advantages and disadvantages of alternative approaches. These could have included limiting the scope and duration of the Guarantee. However, there were concerns that the market would not have acted positively to such a delay at the time. (*Nyberg, p. 93*)

Buying time, even until following week-end, would not have been an idle exercise. It would have allowed the authorities the opportunity to assess more extensively the advantages and disadvantages of the alternative approaches available.... In the best case scenario, there could have been sufficient time to allow for the emergence of an initial common EU approach to the crisis. (*Nyberg, p. 79*)

Guarantee – necessary or not?

As regards the substance of the guarantee itself, it is hard to argue with the view that an extensive guarantee needed to be put in place, since all participants (rightly) felt that they faced the likely collapse of the Irish banking system within days in the absence of decisive immediate action. (*Honohan, p. 14*)

Unlike in the case of the Irish guarantee of September 2008, the Northern Rock guarantee extended only to existing and renewed wholesale deposits; and uncollateralised wholesale borrowing. It did *not* include other debt instruments such as covered bonds, securitised loans and subordinated and other hybrid capital instruments. (See Annex 4 for a discussion of the different classes of liabilities of banks involved. (*Honohan, p. 129*)

On night of the guarantee, the attention of Ministers became concentrated on how to avoid the short term risk of insufficient market funding in the morning. (*Nyberg, p. 79*)

... in all likelihood the main banks would have run out of cash within days. They did not have unused collateral eligible for borrowing at the ECB's facilities in sufficient amounts to meet a run on the scale which would have ensued. Absent Government support or ELA they would have to close their doors also, unable to pay out on cheques presented and other payments instructions. (*Honohan, P. 131*)

In the event, in the following ten days, six other countries introduced blanket deposit guarantees – though none of them were as extensive as the Irish scheme. While this is conjectural more prior consultation on alternative options might have alleviated the pressures on Ireland without creating the tensions prompted by a sudden unilateral action. After all, an EU-wide response to the crisis did eventually emerge in the following week. It is possible that recourse to ELA might have bought some time for such eventualities. In the event, in the following ten days, six other

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countries introduced blanket deposit guarantees – though none of them were as extensive as the Irish scheme. While this is conjectural more prior consultation on alternative options might have alleviated the pressures on Ireland without creating the tensions prompted by a sudden unilateral action. After all, an EU-wide response to the crisis did eventually emerge in the following week. It is possible that recourse to ELA might have bought some time for such eventualities. (*Honohan, p. 134*)

The Guarantee proved initially to be effective as there was a major inflow of funds to the financial system as a whole. However, Anglo was unable to recover the vast amounts of deposits lost in the run up to the Guarantee. (*Nyberg, p. 82*)

Guarantee – Scope right or wrong?

Honohan describes the guarantee’s scope as “exceptionally broad”, including as it did interbank deposits, covered bonds and senior and subordinated debt. Inclusion of long-term and subordinated bonds was not necessary to protect liquidity as these were “locked in”. (*PAC, p. 134*)

The extent of the cover provided (including to outstanding long-term bonds) can – even without the benefit of hindsight – be criticised inasmuch as it complicated and narrowed the eventual resolution options for the failing institutions and increased the State’s potential share of the losses. (*Honohan, p. 14*)

No other country had introduced a **blanket, system-wide, guarantee**, though this has been a relatively frequent tool in previous systemic crises... The inclusion of existing long-term bonds and some subordinated debt (which, as part of the capital structure of a bank is intended to act as a buffer against losses) was not necessary in order to protect the immediate liquidity position. These investments were in effect locked-in. Their inclusion complicated eventual loss allocation and resolution options. Arguments voiced in favour of this decision, namely, that many holders of these instruments were also holders of Irish bonds and that a guarantee in respect of them would help banks raise new bonds are open to question: after all, extending a Government guarantee to non-Government bonds has the effect of stressing the sovereign to the disadvantage of existing holders of Government bonds; besides, new bonds could have been guaranteed separately.... Subordinated debt holders have suffered some losses, given the buy backs that have occurred at discounted prices. Nevertheless, the inclusion of existing debt in the coverage of the guarantee likely increased the potential share of the total losses borne by the State. This eventuality deserved fuller consideration in advance. (*Honohan, p. 128*)

The inclusion of subordinated debt in the guarantee is not easy to defend against criticism. The arguments that were made in favour of this coverage seem weak: And it lacked precedents in other countries (although subordinated debt holders of some other banks since rescued abroad have in effect been made whole by the rescue method employed). Inclusion of this debt limited the range of loss-sharing resolution options in subsequent months, and likely increased the potential share of the total losses borne by the State. (*Honohan, p. 135*)

Effectiveness of reviews of bank loan books and capital adequacy

Bank information

The lack of information on bank exposures among the Authorities over time had profound implications for the decision actually taken. (*Nyberg, p. 94*)

C4 – Policy Responses: Appropriateness and Effectiveness of Policy Responses

Decision to nationalise Anglo in 2009 and alternatives available/considered

Decision

Having particular regard to Anglo's interconnectedness with the Irish banking system, it must be regarded as having been of systemic importance to the Irish banking system and could not have been allowed to fail. A disorderly failure would have caused lenders to avoid all Irish banks and without Government support or ELA they would have had to close (*Honohan 8.41 –8.43, Box 8.4 p.131, and PAC, 135*).

On 9 January 2009 the Chief Executive of the Financial Regulator announced his retirement following the Financial Regulator's internal investigation into the Anglo directors' loans issue. That issue, combined with as-yet unpublicised information concerning back-to-back loans with ILP and loans relating to the Quinn Group's shareholding in Anglo, prompted the Government to announce the nationalisation of Anglo on 15 January 2009. (*PAC, p. 138*)

Establishment and operation of NAMA

Establishment and operating model

As part of the Emergency Budget in April 2009, the Minister for Finance announced a "bad bank" programme of acquisition of impaired bank assets as a means of providing liquidity to banks and improving their ability to raise capital on the markets. This was to be affected through the National Assets Management Agency (NAMA) established under legislation passed later that year.

NAMA functions by buying impaired loans from banks at a discount that reflects the loans' "long-term economic value". NAMA pays for the loans by means of bonds that the receiving bank can either hold or use as a means of raising liquidity from the Central Bank or ECB. Mr Brendan McDonough, Chief Executive of NAMA, cited "huge systems failures" in the banks leading to unrealistic valuations of loans in 2009, and agreed that "false and misleading information" was given to NAMA about them. As a result, NAMA takes a very strict approach to loan valuation, resulting in discounts averaging 53%, in contrast to the average of 30% suggested by some banks in 2009.

NAMA seeks to recover the full nominal value of the loan from the borrower. Where the underlying project for which the loan was granted appears unlikely to generate value, NAMA may move to realise the security (by way of receivership or sale of the secured property or other assets) or by calling in personal guarantees. Where the project for which the loan was granted appears to offer a prospect of a return within 3–5 years, NAMA is prepared to work with the borrower to achieve as much value as possible.

Returns on loans are applied first to recoup the sum NAMA paid to the bank for them. Any net surplus will be remitted to the banks from which they were bought. (*PAC, pp 142-3*)

After the banks have sold their largest property-related exposures to the State's asset purchase vehicle, NAMA, at a price based on their estimated —long-term economic value, and after they have made provision for all of their other prospective loan-losses the State will have taken sizeable equity stakes in most of the banks, and issued some €40 billion or more in Government-guaranteed NAMA bonds (in exchange for which NAMA will hold loans of a similar value). (*Honohan, p. 19*)

Scale of business

[In net terms, the State will have] issued some €40 billion or more in Government-guaranteed NAMA bonds (in exchange for which NAMA will hold loans of a similar value).

By December 2010 NAMA had purchased 11,000 loans involving approximately 850 borrowers and having a total nominal value of €71 billion. The price paid in bonds for these was approximately €41 billion, giving an average discount of nearly 58%. [58% does not tot, should be 42%]

In 2010 Mr Peter Matthews criticised the NAMA strategy, arguing that experience in US bank crises indicated that direct investment in the banks while leaving the impaired loans in place generated up to 10-fold returns. (*end of PAC extract*)

NAMA has to date paid the banks €32 billion for property development loans valued at €74 billion. However, the CAG estimates that for the first five tranches of loans transferred, NAMA paid 23% over their current market value, subsidising the banks by approximately €5 billion. (*PAC, p. 13*)

An even more revealing illustration comes from the multi-bank inspection carried out late in 2007, by which stage concern was growing about the large lending to property developers. Given that the portfolio being examined was eventually purchased by NAMA at a large discount, it is clear from the elements mentioned in Box 5.2 (Appendix) that the system was not set up in such a way as to detect even serious portfolio weakness, let alone quantify it (*Honohan, p. 70*) – see Appendix on Inspection in 2007

Appendix 1 of Honohan on 5 x 5 Big Developer Inspections, 2007

Box 5.2 - The 5 x 5 Big Developer Exposures Inspection, 2007

In December 2007, evidently reflecting a belated heightening of concern about large commercial property lending exposures, the FR embarked on a special multi-institution inspection to look at the handling by five banks of five large exposures. Complacently, —all institutions confirmed to the inspectors that they have no concerns with the current or future repayment capacity of any of the borrowers included in the inspection to which they are exposed. This optimism subsequently proved in all cases to have been mistaken.

The inspection nevertheless identified two —High Priority findings, both related only to a single institution. In line with the usual house supervisory style, these related to process rather than specific exposure issues. Thus, the inspectors noted (p. 11): —it appears that there is no comprehensive review of Group exposures conducted on an

Crisis Management: Selected Extracts from 5 Banking Reviews

annual basis. Rather reviews concentrate on an ongoing high-level review of exposures and do not appear to involve a review of documentation such as Audited Financial Statements, Cash Flow Statements etc. And, —The inspectors were advised that certain valuation updates are based on ‘management estimates. However, such estimates (which may be performed by the [identified senior management officer]) do not appear to be recorded. It is clear that the inspectors have detected a deeply flawed process, which should have caused great alarm.

Turning to what the inspectors classed as —Medium Priority findings (M), several show how much trust the banks were placing in the unverified assertions of their borrowers with regard to their personal wealth, and how inaccurate some of the information being used by the banks was. Thus, consider the following :

M1: —The inspectors noted that institutions have been unable to obtain a Net Worth Statement from [Mr. X], as he is unwilling to disclose such details in writing. In addition, the statements provided by [Mr. Y and Mr. Z] have not been certified by a third party.

M2: —The inspectors noted that some estimates provided to the inspectors as to the overall indebtedness of Group exposures appeared to differ significantly from data available to the inspectors, e.g., [Bank A] advised that they believed the [Z] connection indebtedness to [Bank B] to be circa [€P00m], whereas the data provided by [Bank B] advise that the debt is currently circa [€1 billion more]. While such differences may arise because assessments are based on information obtained at different times, nevertheless the inspectors would question the manner in which institutions appear to be assessing Group Indebtedness as evidenced by the following:

- (a) [Bank A] reviews the overall indebtedness to all credit institutions of [Mr. X] through discussions with [Mr. X] and his senior management team. However, no record is maintained of such discussions and as a result the inspectors were unable to obtain evidence that indebtedness had been reviewed.
- (b) [Bank A] does not review the overall indebtedness to all credit institutions of [Mr. X] and the [Z] Connection, as [Bank A] focuses only on its own exposures and related security in these cases.
- (c) The overall indebtedness of [Mr. Y] to all credit institutions is reviewed by [Bank A] through a review of his Net Worth Statement. On the basis that this statement is not certified by a third party, the inspectors would question whether this document should be the only source for assessing overall indebtedness used by the bank.

M10: Inspectors expressed concern about the adequacy of Bank D’s understanding of its exposure to Z and W based on minutes of its credit committee:

“Chair echoed the Committee Members views, stating that whilst he acknowledged that the team had an understanding of each of the individual projects we were engaged with, the group as a whole was a much more complex entity by its very nature. Consequently, chair said that the opaqueness in the Bank’s understanding of the wider group and our limited executive contact with [Mr Z], was extremely disappointing and reiterated that there is a clear need to escalate the level of understanding. In addition, the minutes also noted that —the bank lacked a real understanding of the wider group liquidity, and we were unable to explain the inherent structural risk”.

Crisis Management: Selected Extracts from 5 Banking Reviews

The [Bank D] Credit Committee meeting on 26 September 2007 stated: “Chair noted that the bank was not in a position where it had a full understanding of [Exposure W]’s liquidity”. “It was thus strongly emphasised that the bank needed information as to how [W] will generate cash and what its wider strategy is, as well as gaining further insight into its local strategy in relation to the build-up of assets around [identified UK location]”. The minutes also noted that “the bank was now heavily exposed to this group and uncertain at this stage whether [an amount in excess of €500 million] was the right number to be basing our appetite”.

M16: “The inspectors were advised that the calculation by [Bank E] of [Mr. X]’s net worth included [an amount in excess of €100 million] which represents working capital facilities provided by the bank. It was not clear to the inspectors how such debt increases [Mr. X]’s net equity.”

Despite this catalogue of banking deficiencies, the full implications of the obvious lesson – that loan appraisal had been wholly inadequate and personal guarantees could not to be relied upon – does not appear to have been taken on board by the regulatory system. Certainly, the implication that the solvency of all of the banks could be at risk given the declining value of collateral that must have already have been clearly in prospect was not one that was understood by the Authority. An indication that the participants in the exercise seem to have remained fairly relaxed about the findings is given by the perfunctory – or at least brief – character of the post-inspection close-out meetings (20 to 30 minutes). At this rate, how much regard can the banks have had for the inspectors

Decision to recapitalise Anglo, AIB, BoI, EBS, PTSB and alternatives available/considered

Anglo

After the decision to issue the guarantee, AIB and BoI were asked to provide Anglo with immediate short-term liquidity. The two banks agreed to provide a total of €5 billion for a matter of days, subject to Government guarantee. The Central Bank also agreed to allow Anglo a €3 billion liquidity facility, which, following the inflow of funds consequent to the guarantee, Anglo did not draw upon (*Honohan 8.31 –8.32, PAC, p. 134*).

Against this background, work intensified on recapitalisation options with the extensive input of Merrill Lynch. On November 28, the Minister announced that, on the basis of a report that analysed the loan books of the major financial institutions, their capital levels would remain within regulatory requirements in the period through to 2011 even under certain stress scenarios. However, in certain circumstances it would be appropriate for the State “to consider supplementing private investment with State participation”. Following a negative market reaction to the release of Anglo’s end year results, on December 14 the Government announced a recapitalisation programme of up to €10bn.¹⁴⁵ However, the positive impact of this decision was undermined by the emergence of the “loans to Directors” issue at Anglo which led to the resignations on December 18 and 19 of the Chairman and CEO of Anglo respectively. On December 21, announcements were made regarding the capital injection of €1.5bn into Anglo and €2bn each into both Bank of Ireland (BoI) and Allied Irish Bank (AIB). (*Nyberg, p. 84*)

Anglo & INBS

The State will also have had to write-off in the order of €25 billion in unrecoverable capital injections into two institutions – Anglo Irish Bank and INBS – whose prospective loan losses greatly exceed their initial accounting

Crisis Management: Selected Extracts from 5 Banking Reviews

capital (*Honohan, p. 19*)

Bank recapitalisation

The direct cost to the State –through the recapitalisation of the banks –is now estimated to be €64.1 billion. This has been funded in part through using the State’s own resources in the National Pensions Reserve Fund (NPRF), from which €20.7 billion has been invested in Allied Irish Bank (AIB) and Bank of Ireland (BoI). However, the majority of funding has come from borrowing. The general government debt *directly* related to the bank bailout is €43.4 billion, a figure that includes the €31 billion in promissory notes used to fund the liabilities of Anglo Irish Bank (Anglo), the Irish Nationwide Building Society (INBS) and the Educational Building Society (EBS). (*PAC, pp 12-3*)

To put this cost in context, the direct cost of €64.1 billion is equivalent to —

- 41% of GDP in 2011;
- Approximately seven times what the State spends annually on education;
- Over four times what it spends annually on health;
- Over three times what it spends annually on social protection; and
- Almost twice the State’s total tax revenue. (*PAC, p. 13*)

Scale of Guarantee

The gross amount of liabilities guaranteed [at end-September 2008] came to €365 billion, or almost 2½ times GNP. (*Honohan, p. 19*)

At the end of 2011, the contingent liability from guarantees stood at €173 billion (110.3% of GDP) and the latest figures available to the Committee suggest that the total liability under guarantees fell by approximately €6 billion in Quarter 1 2012. (*PAC, p. 14*)

6

International Economic Consultants

Indecon

Status: Personal and Strictly Confidential

Addressee Only

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

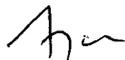
25th September, 2008

Dear Kevin,

Please find a confidential personal note in the attached envelope.

Kind personal regards,

Yours sincerely,



Alan W. Gray

Status: Personal and Strictly Confidential

Addressee Only

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

25th September, 2008

Dear Kevin,

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

If I can be of any further assistance just call.

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

Kind personal regards,

Yours sincerely,



Alan W. Gray

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

STRICTLY PERSONAL – STATUS SECRET

CHALLENGES

- A. IMPROVE LIQUIDITY IN BANKING SECTOR.**
- B. RESPONSE TO INDIVIDUAL BANKS WITH SPECIFIC LIQUIDITY ISSUES.**
- C. ACTIONS TO REDUCE RISK AND POTENTIAL EXCHEQUER EXPOSURE IN SPECIFIC INDIVIDUAL BANKS.**
- D. PLANNING TO FACILITATE RESTRUCTURING OF SECTOR.**

A. Improve Liquidity in Banking Sector

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

B. Response to Individual Banks with Specific Liquidity Issues

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

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

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

D. Planning for Restructuring of Sector

Needs significant thought and analysis.

Principles Inherent in Above Analysis

- (i) State exposure to be minimised where possible.
- (ii) The knock on impacts of any decisions taken into account and minimisation of contagion.
- (iii) The cost of any assistance to be paid for fully by the sector (even if this means over time).
- (iv) Wider economic implications factored in.

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

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

MARCH 2011

generally saw little problem in expanding their lending by allowing credit quality and risk management to gradually erode. Likewise, households and investors had seen their incomes and wealth increase markedly for a number of years; easy access to credit further encouraged belief in a never-ending boom. In essence, both sides of the market assumed that the other side knew what it was doing. This helped ensure continued growth, profitability and funding in the market in the short term. However, this also meant that risk-related brakes on the growth of credit and leverage were weak and were growing weaker over time.

As banks increasingly funded the apparently profitable property market, a widespread and accelerating credit-financed boom in residential and commercial property developed from the first half of the decade. A self-reinforcing spiral developed: higher prices and values caused increased speculative buying of housing and land; evaluators based their estimates on these higher prices; this increased the demand and collateral for bank lending, which in turn raised prices as more funding was provided. This development ended as housing prices reached their peak at the end of 2006 and construction in early 2007. Furthermore, as bank funding dried up, the credit-driven property development sector started to experience liquidity problems. From then on, the link between property prices and funding accelerated the downturn and reduced banks' perceived creditworthiness, particularly as international accounting standards had prevented more prudent provisioning for possible future losses during the growth phase of the cycle.

Consensus

A majority of the people interviewed by the Commission indicated that they saw no major problems except lack of liquidity until the end of 2007, at the earliest, and autumn 2008, at the latest. The reasons given were usually very similar, the most prevalent being: property prices in Ireland had never decreased markedly; everybody expected a "soft landing" at worst; loan portfolios appeared sound; property credits were diversified by country or county or class; peer banks abroad did the same thing; and "nobody told them" there was a potential problem.

A minority of people indicated that contrarian views were both difficult to maintain during the long boom and unhealthy to present to boards or superiors. A number of people stated that had they implemented or consistently supported contrarian policies they may ultimately have lost their jobs, positions, or reputations. Other signs were also noted pointing to sanctioning of diverging or contrarian opinions as well as self-censorship because of this. The apparent strength of these expected sanctions is difficult to judge, but the absence of opposition, barring only a handful of identified vociferous contrarians, may have made it easier for institutions to accept toning down the application of vital, tried and traditional prudential practices.

The Commission suspects that this conformity of views and self-limitation of responsibility would have tended to reduce the perceived need for monitoring, checking and thinking about what was really going on. There would have been little appreciation – both domestically and abroad – of the fact that Irish economic growth and welfare increasingly depended on construction and property development for domestic customers, funded by a growing foreign debt.

The Commission considers that this pervasive pressure for consensus may explain why so many different parties in Ireland simultaneously were willing to adopt specific policies and accepted practices that later proved unsound. At the same time, the apparent consensus of banks and authorities around the view that markets remained sound and prospects remained positive gave further comfort to both. A number of banks essentially appear to have followed the example of peer banks in a “herding” fashion; there is little evidence of original critical analysis of the advantages and risks of the policies. Widespread lack of critical discussion within many banks and authorities indicates a tendency to “groupthink”; serious consideration of alternatives appears to be modest or absent. A tendency to favour silo organisation and submissiveness to superiors strengthened this effect, particularly among the public authorities.

In designing the constraints and rules for banking in the future, full account will need to be taken of the failure of private and public institutions to appreciate the emerging risks and to take action. If responsible authorities are affected by the prevailing paradigms, they cannot be expected to uncover its risks and weak points. Financial systems should, in that case, be designed to be as stable as possible even in the absence of unfailingly vigilant and prescient regulators and central banks.

Flawed lending: Anglo and INBS

Anglo and to a much lesser extent INBS are important for the wider crisis because they were both seen as highly profitable institutions to which other Irish banks should aspire. As other banks tried to match the profitability of Anglo in particular, their behaviour gradually, and even at times unintentionally, became similar. Accordingly, when the crisis broke, large losses were realised not only in Anglo and INBS but in other banks as well.

Contrary to public perception at the time, lending at Anglo and INBS had proceeded with insufficient checks and balances during the Period. Relationship lending, high-growth strategies and rapid credit decisions meant that their balance sheets increased as the projects of preferred customers grew. Traditional risk evaluation procedures and risk mitigants were not implemented in practice. Additionally, these banks were very dependent on wholesale funding due to their rapid asset growth and a lack of sufficient growth in customer deposits. As wholesale funding tends to be much more volatile than customer deposits, they were particularly vulnerable to any doubts regarding their own solvency or that of their borrowers.

Governance at these banks also fell short of best practice. While procedures and processes in Anglo existed on paper, in certain cases they were not properly implemented or followed in practice. It appears that, at least in the latter years, only a handful of management was aware of all activities of the bank. At INBS, a number of essential, independent functions either did not effectively exist or were seriously under-resourced.

The Financial Regulator(FR) was clearly aware of many of these problems in the two banks. Prior to the commencement of the Period, and consistently throughout, it raised significant concerns regarding governance at INBS. It also submitted a comprehensive list of procedural and portfolio problems to Anglo. It furthermore raised minimum capital ratios for both banks. However, such remedies did not prove effective to ensure sufficiently greater prudence and accountability in either of the banks. The

Chapter 2 - The Problems with the Banks

2.1 Introduction

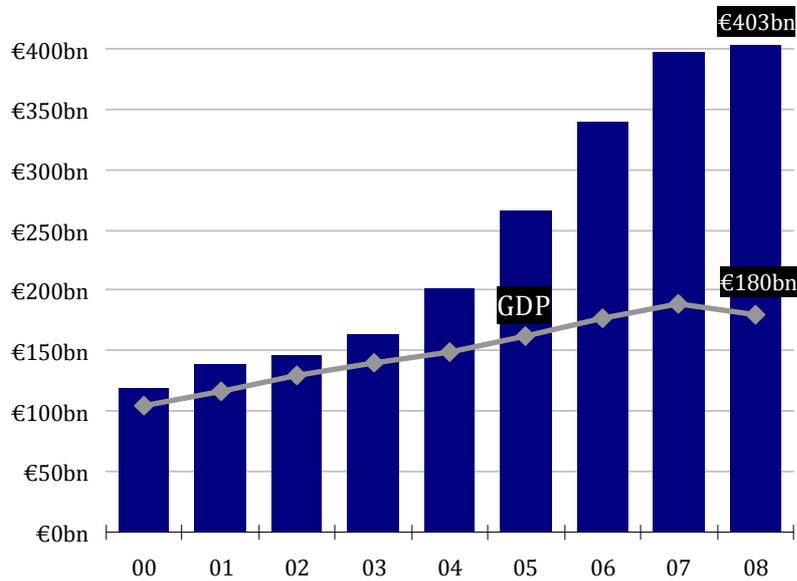
- 2.1.1 This Chapter addresses the issue of why the covered banks operated in a way that eventually made substantial State support necessary. The process leading up to this result took several years, with loan growth accelerating during the latter years of the Period. This progression also required that a number of functions and units within the banks allowed, ultimately, imprudent practices to develop.
- 2.1.2 The Commission has not and could not assess the actions or inactions of single individuals in organisations and did not think it was appropriate or fair to do so. Firstly, the time limit set for the investigation does not allow for that level of forensic scrutiny. Secondly, major changes in banks tend to take place as a consequence of complex interactions between a number of people; isolating any one influence would be very difficult. This is particularly true of units within a bank, such as Committees or the Board. In the view of the Commission, it is not generally possible to infer, from an investigation of how a certain unit in the bank functioned, how its members operated individually. Therefore any reference to a bank, its Board or any of its Committees or functions is not intended as a reference to any individual.

2.2 Setting the Scene

High growth in lending delivering reported bank profit and market value uplifts

- 2.2.1 For much of the Period, Ireland's banking sector and the covered banks were characterised by rapid balance sheet growth driven primarily by property lending in Ireland.
- 2.2.2 Figure 2.1 below illustrates the scale of growth in lending by the covered banks, rising from a stock of €120bn in 2000 to almost €400bn by 2007. The three years ending in 2006 marked the highest sub-period of sustained growth, with loan assets more than doubling overall, growing at a compound rate of almost 28% per annum. This rate of growth significantly outpaced growth in Gross Domestic Product (GDP). By the end of 2007, total loans and advances to customers stood at over twice GDP, up from 1.1 times GDP in 2000.

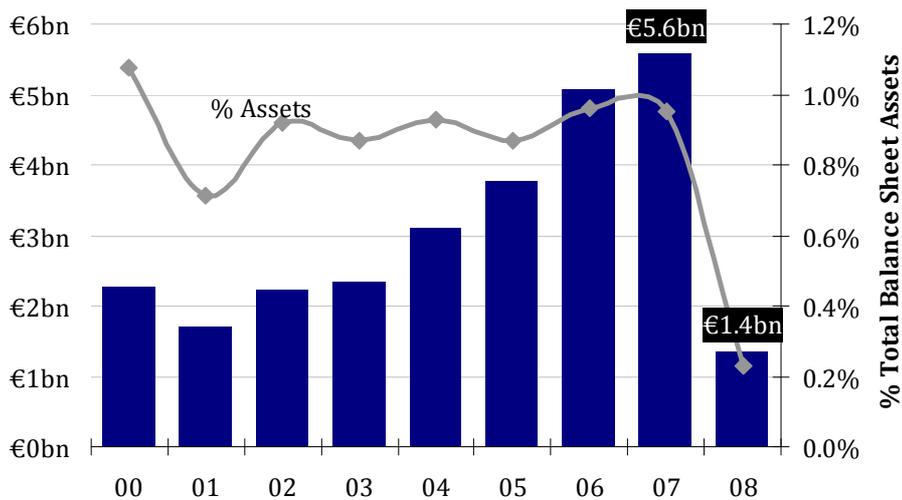
Figure 2.1 Covered Banks – Loans and Advances to Customers 2000-2008



Source: Annual Reports & Eurostat

2.2.3 Figure 2.2 below shows reported profits up to 2008 for the covered banks. Up to 2007, reported return on assets was broadly maintained appearing to indicate that asset quality was consistent with previous periods. Within the combined figures set out below, Anglo Irish Bank (Anglo) and Irish Nationwide Building Society (INBS) reported very substantial growth in profits after tax of 826% (€899m) and 535% (€260m) respectively between 2000 and 2007.

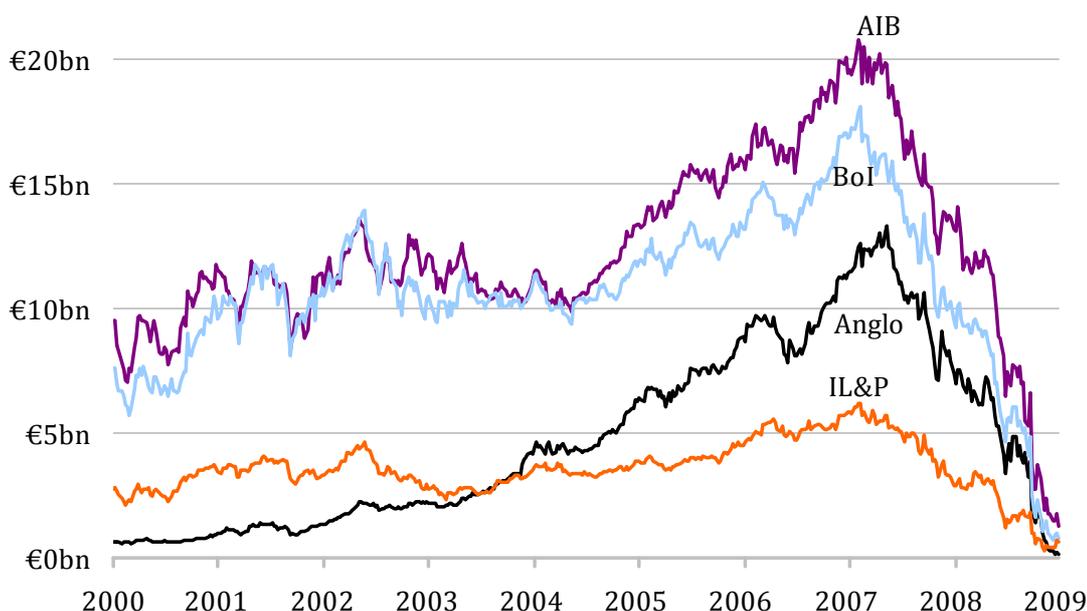
Figure 2.2: Covered Banks – Aggregate Profit After Tax 2000-08



Source: Annual Reports

2.2.4 The growth in reported profits of the covered banks was reflected in the significant upward movement in the share prices and resultant market capitalisations of the four listed banks (Figure 2.3). From January 2000 to its peak in February 2007, the combined market capitalisation of the four banks rose from €20.4bn to €57.4bn. Anglo's market capitalisation is particularly notable, growing over 2,000% from €0.6bn in 2000 to a peak of €13.3bn in mid 2007.

Figure 2.3: Individual Market Capitalisations of Listed Covered Banks 2000-Jan-2009



Source: Irish Stock Exchange

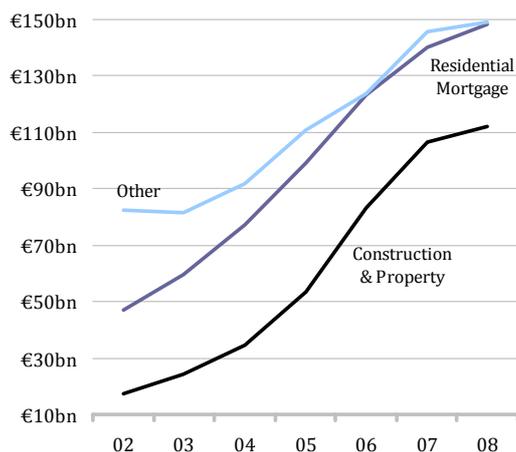
Components of Overall Lending Growth

2.2.5 Lending growth was very uneven between sectors. Figure 2.4 below illustrates the growth in components of domestic private sector credit, i.e. lending to Irish resident businesses and citizens, over the period 2002 to 2008. What clearly emerges is the extent to which property-related segments, i.e. residential mortgage lending and lending to the construction and property (C&P)²⁴ sector, significantly out-paced growth in all other sectors combined. In absolute terms, over the period 2002 to 2008, domestic property-related lending increased by almost €200bn which represents 80% of all growth in credit. This raised the share of property-related lending from under 45% of total credit in December 2002 to over 60% in December 2008.

²⁴ Within Loans and Advances to Customers, "Construction and Property" was the categorisation used by some banks to cover lending for investment property as well as site purchase and development (i.e. not including residential mortgages). For ease of reference, in this chapter we will describe property generating a recurring income as Investment Property and use the term development finance to describe lending for building related funding to both the residential and commercial sectors, including site finance.

2.2.6 In the key period of high growth from 2004 to 2006 (see Figure 2.5 below), net lending to the C&P sector increased at a compound annual rate of almost 45%, enough to treble exposure in this sector over this period.

Figure 2.4:
Private Sector Credit 2002-08



Source: Central Bank of Ireland

Figure 2.5:
Annual growth in selected components 2003-08



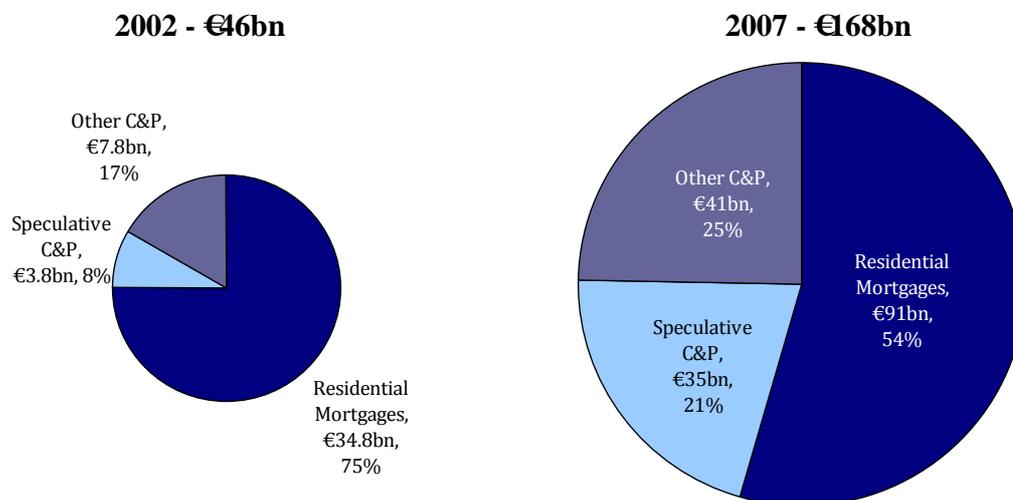
2.2.7 Over the period 2002 to 2008, aggregate domestic lending to residents in Ireland fluctuated within the range of 64-68% of the covered banks' loans and advances to customers, indicating no significant diversification away from Irish resident borrowers.

The Covered Banks

2.2.8 The covered banks accounted for over 65% of the overall growth in property-related lending in Ireland over the period 2002 to 2007. Their domestic property lending to Irish residents grew by 262% to €168bn by December 2007 (see Figure 2.6 below). In addition to the very strong overall growth, there was a dramatic change in the distribution of this lending between Residential Mortgage, Speculative C&P lending²⁵ and Other C&P lending. The proportion of loans for speculative C&P projects increased from 8% to 21% of all loans by December 2007. The proportion of residential mortgages fell from 75% to 54% but still more than doubled in size.

²⁵ Speculative C&P lending (a subset of overall C&P lending) is in respect of C&P projects where no construction or rental contract is yet in place.

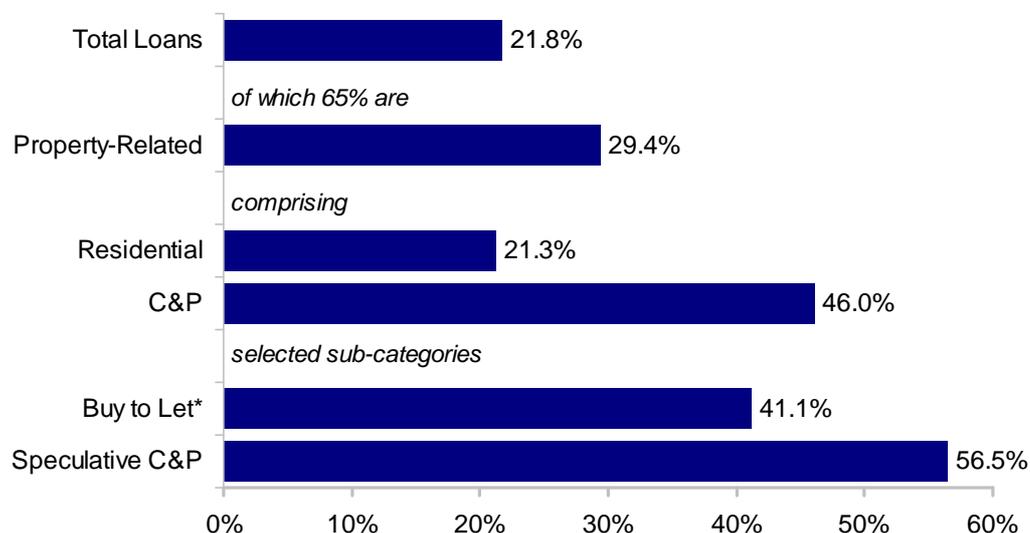
Figure 2.6: Components of Aggregate Domestic Property Lending Stock to Irish Residents by the Covered Banks



Source: Central Bank of Ireland

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

Figure 2.7: Domestic Lending by Covered Banks to Irish Residents: Compound Annual Growth Rates for selected Sectors 2002-07

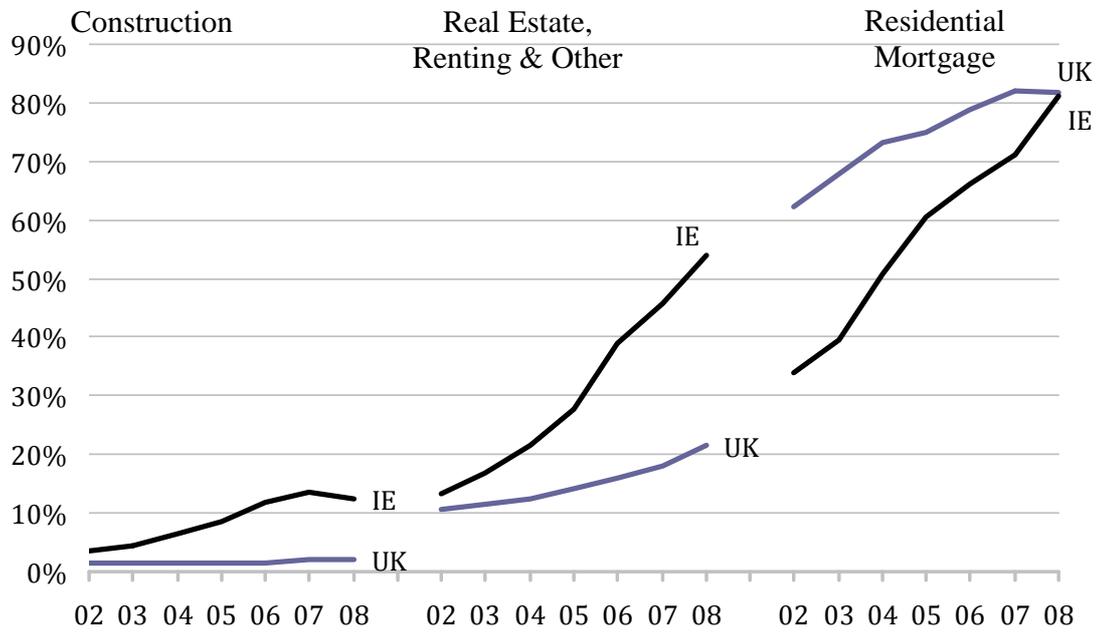


Source: Central Bank of Ireland
*2003-2007

2.2.10 From Figure 2.7, it is clear that the covered banks collectively (and to varying degrees individually) were increasingly concentrated in property related lending to Irish residents and had rapidly grown their exposure to domestic C&P in particular.

2.2.11 The rate of increase in property lending was markedly more rapid in Ireland than, for instance, in the UK relative to GDP. The aggregate of the property-related lending to residents by domestic banks, the components of which are illustrated in Figure 2.8 below, stood at over 147% of GDP at the end of 2008, compared to less than 106% of GDP for the UK domestic banking industry. Lending in the three identified property related segments increased at faster rates than the equivalent segments in the UK, particularly in C&P lending. The covered banks' exposure to C&P lending had grown to over 48% of GDP by 2008, up from 11% in 2002. In the case of residential mortgage lending, the UK was relatively more indebted at the start of the period, but Irish lending had matched the UK in relative terms by the end of 2008.

Figure 2.8: Domestic Property Related Lending as % GDP: Ireland & UK Comparison

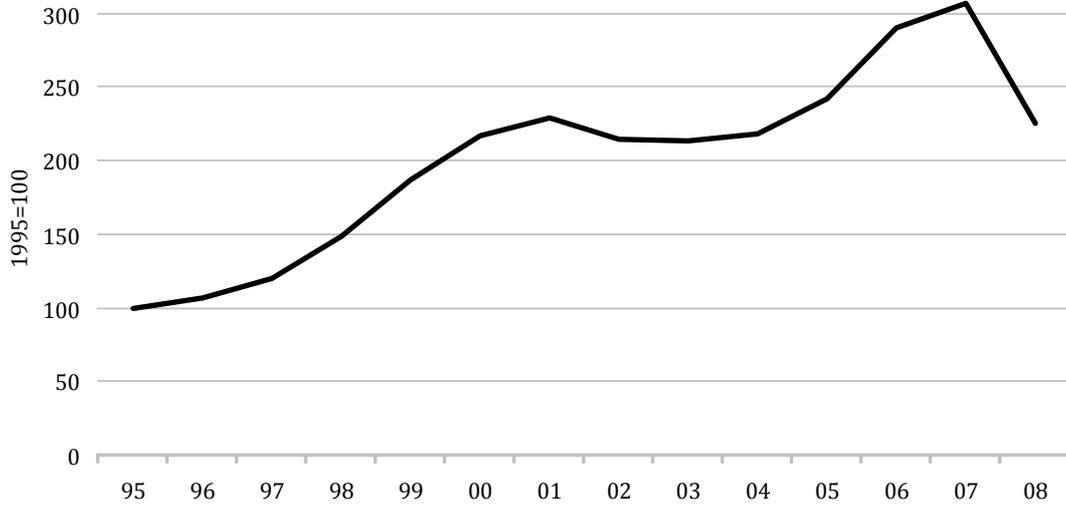


Source: Central Bank of Ireland, CSO, Bank of England & UK ONS

2.2.12 As credit to the property sector grew, real commercial property values increased between 1995 and 2007 by about 200% (see Figure 2.9 below). Residential prices rose by more than 180% over the same period. Figure 2.10 below shows housing completions and real price increases between 1976 and 2008. The sustainable level of house construction, which was predicated on continued economic growth and immigration, was estimated in 2005 to be in the region of 60-70,000 units per annum²⁶. The upper level of this range had been exceeded for the first time in 2004.

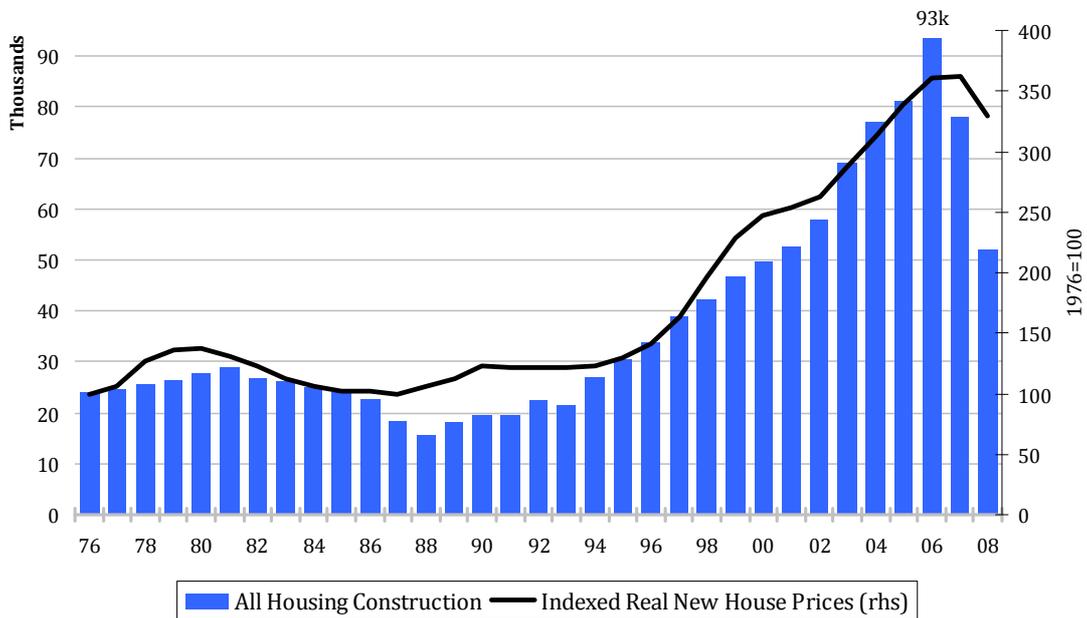
²⁶ ESRI Medium Term Review 2005-2012, published December 2005.

Figure 2.9: Real Indexed Commercial Property Values – Combined Office, Retail & Manufacturing



Source: Investment Property Databank

Figure 2.10: New House Prices (Real) & Housing Construction, 1976 – 2008

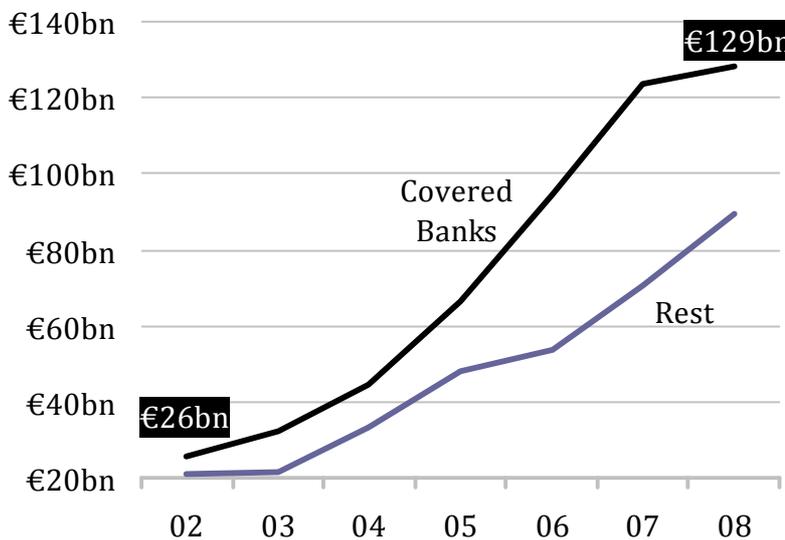


Source: DOE & CSO

Funding the Covered Banks' Lending Growth

2.2.13 As the covered banks' domestic lending grew so substantially, retail and corporate deposits could not provide sufficient funding. Figure 2.11 below illustrates how the funding gap developed for both the covered banks and those of the domestically active non-covered banks between 2002 and 2008. The covered banks' requirement for non-deposit funding increased almost fivefold over the period from €26bn to €129bn and grew at a particularly high rate from 2004 to 2007. The rest of the banks had a similar though generally smaller funding gap. This funding gap was financed by wholesale market funding and largely represented increasing foreign borrowing by the banks. This foreign debt was used largely to fund the domestic property market.

Figure 2.11 Funding Gap – Excess of Domestic Lending to Residents over Deposits



Source: Central Bank of Ireland – 31-Dec of each year

2.2.14 In summary, by the middle of the Period, investors were piling into residential and other real estate projects and property prices were rising, causing demand for financing to increase markedly. Banks were fuelling this demand by expanding their loans books at very high annual rates of growth. The banks were, in turn, willingly financed in the funding markets by domestic and foreign investors. As it eventually turned out, this process gradually fulfilled the first three conditions (as set out in paragraph 1.4.3 above) for the occurrence of a systemic financial crisis. The rest of this Chapter examines in more detail how the covered banks responded to the growing demand for property finance and how their internal governance, rules and procedures were adapted to reflect changing strategies.

2.3 Market Shares Threatened

2.3.1 In the years leading up to the beginning of the Period, competition in the property lending markets increased as the Irish banking sector became subject to increased foreign competition.

Competition in the residential mortgage market was traditionally intense with each of the covered banks (with the exception of Anglo, which did not offer residential mortgages) fighting for market share. The entry of Bank of Scotland into the Irish mortgage market in 1999 led to increased lending competition and reduced profit margins as it offered mortgages at substantially lower interest rates than domestic banks at that time. Furthermore, the acquisition of First Active by Ulster Bank (part of the RBS Group) in January 2004 increased its share of residential mortgages to 15%, giving Ulster Bank the scale to be a significant lender. The foreign-owned institutions competed aggressively with the domestic players for market share offering not only more attractive terms but also new residential mortgage products (e.g. high/100% loan-to-value mortgages, interest only mortgages, tracker mortgages etc).²⁷ These new products, however, also posed new risks for both the borrower and the lender.

- 2.3.2 Leading up to and during the Period, competition in the commercial property lending market also intensified. A number of foreign owned banks, but also Allied Irish Banks (AIB), escalated their commercial property lending activities with the main objective of growing earnings and retaining or increasing market share. These banks were soon followed by Bank of Ireland (BoI). This increased competition would have threatened the market shares primarily of the banks already concentrated on property lending. However, as the credit-induced growth in the property sector in Ireland continued and as property values increased, each bank could simultaneously increase lending for (and reported profits from) property without much market share change.
- 2.3.3 It was against this backdrop that the covered banks pursued strategies which would lead to higher growth, higher reported profits and higher bank valuations. A primary reason appears to have been to prevent a predatory takeover by another bank (either domestic or foreign) and thus maintain independence. However, in a number of cases, professional pride and a desire to catch up with or stay ahead of the competition (i.e. playing to win) also seem to have been important.
- 2.3.4 The new strategies were based on the assumption that property demand would remain strong and values would continue to increase. Great comfort seems to have been taken from the specifically Irish experience from earlier years; previous slowdowns had not resulted in property crashes and price declines, if any, were relatively modest (see again Figures 2.9 & 2.10 above). Furthermore, a great number of credible authorities and experts were stressing that

²⁷ Mortgage intermediaries began to emerge as a force in the residential mortgage market in the mid-1990's, initially as a distribution channel for non-branch based mortgage lenders. Due in part to alliances with estate agents they exercised significant control over the "first time buyer" market in particular. This market was viewed by lenders as an attractive market segment and key for customer acquisition and exit financing for development lending. At the peak of the market in 2005 mortgage intermediaries accounted for about 45% of new residential mortgage loans. Against this background, intermediaries were able to leverage their relationships with lenders pushing for better mortgage terms (and sometimes larger loans). This led to a considerable reduction in bank margins (interest and commission). Many banks sought to compensate by increasing loan volumes to maintain earnings. While these changes impacted on the mortgage market, mortgage intermediaries had only a limited and indirect impact on the banking problems which are the subject of this Report because, in the final analysis, intermediaries did not make the lending decisions.

various “unique Irish circumstances” (e.g. demographic, immigration, catch up in terms of living standards, shortage of housing) would, at worst, guarantee a “soft landing”²⁸ in the event of an economic downturn. It was furthermore assumed that low-cost wholesale funding, which was necessary to finance the rapid growth in property lending, would continue to be widely available. These optimistic assumptions, strongly held and built on relatively recent trends specifically in Ireland, later proved to be the downfall of all the covered banks.

2.3.5 The rest of this Chapter reviews developments related to some of the essential procedures and control functions of the covered banks. While the banks broadly ended up making fairly similar mistakes, relying on wholesale funding and lending excessively to property projects, there were otherwise large differences between them. Despite this, it appears that all covered banks remained convinced that their business models, strategies and operations were sufficient to ensure unproblematic, continued and successful growth.

2.4 Business Models and Strategies

Anglo

2.4.1 Anglo concentrated almost entirely on business banking. Its core strategy was to provide bespoke banking services to well-defined target markets. The main driver of business and profit growth was business lending involving the provision of commercial mortgages and asset financing (mainly property) on a secured basis. It wanted to “grow with its customers” while simultaneously diversifying its business geographically (in both the UK and the US). The bank classified itself to customers, rating agencies, funders and the authorities as a “relationship based business bank with a centralised business model operating in three core areas – Business Banking, Treasury and Wealth Management”. Customers were described as “experienced business professionals” and loans were to be “supported by secure cash flows and strong collateral”. In particular, business lending, which was classified as “secured term lending”, was presented as the Bank’s core offering and main driver of revenues and profitability.²⁹

2.4.2 Notwithstanding this description of itself as a broadly based business bank, in reality Anglo actually catered for a relatively limited number of customers, many of them in the property development sector. The bank felt confident that a good knowledge of its customers, asset security and personal recourse, combined with geographic diversification of its loan book, would reduce the risks inherent in its property lending model.

2.4.3 Retail deposit funding was less available to Anglo than the full-service banks due to its small branch network. As a consequence, Anglo put huge effort into developing retail funding using a

²⁸ A term used to describe the shift of economic growth from high to low, or potentially flat, while avoiding recession.

²⁹ The extracts in this paragraph are taken from the September 2007 Annual Report of Anglo. It also reported that the bank delivered its 22nd consecutive year of uninterrupted earnings growth with underlying profits increasing by 44% to a record €1,221m. The excellent performance was attributed by Anglo to “its disciplined and focused business model, prudent risk appetite and very limited exposure to areas affected by current credit market issues”. This annual report provided details of risk concentration by geographic location but did not provide a detailed breakdown by sector. Accordingly, there was no reference to C&P lending other than a specific comment that “the Bank does not engage in speculative development lending”.

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

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

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

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

Willingness and Ability to take Action

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

4.4.3 Such a narrow interpretation of the CB's role is not shared by the Commission. When combined with the static¹⁰⁸ approach of the FR in assessing individual institutions, it could – and did – create a situation where financial stability problems could not be addressed or prevented. Financial stability should be the overriding objective and the CB (as well as other responsible authorities) should do whatever is reasonably necessary to maintain it.

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

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

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INBS Options

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”.

PWC reported on the Anglo loan book – 13 billion land/development under way of which 700m unzoned; 4.5 billion zoned no planning; over 3 billion zoned with planning; balance incomplete development

Of the other 55 bn there was a broad mix of income generating assets.

It would be difficult for them to convert their loans to useful collateral, with the exception of an amount of around 2.2bn.

There was a discussion of various forms of state interventions. The FR (Pat Neary) said that there is no evidence to suggest Anglo is insolvent on a going concern basis – it is simply unable to continue on the current basis from a liquidity point of view. He felt INBS was in a similar situation.

D Doyle noted that Government would need a good idea of the potential loss exposures within Anglo and INBS – on some assumptions INBS could be 2bn after capital and Anglo could be 8½.

Various intervention possibilities were discussed: 'Ordinary' liquidity support, SLS-type scheme, guarantees, nationalisation, bad bank approach.

A subsequent meeting took place to present conclusions and possible approaches.

Attendance:

Baldock & Prasath, Merrill Lynch
Pat Neary, Jim Farrell FR
Governor, Tony Grimes CB
Dan O'Connor PWC
Eugene McCague Arthur Cox
Attorney General
Taoiseach
SG to the Government
Minister for Finance, D Doyle, K Cardiff Department of Finance
CEO NTMA
J Corrigan NTMA
Basil Geoghegan (for a short part)

The issue and options outlined at the previous meeting were presented by KC who underlined the urgency of the situation. It was agreed that work would continue on the intervention possibilities outlined, and on preparing the relevant legislation.

Table 1: property, construction and mortgage lending exposure

	Combined 30Sep-08 €bn	AIB Sep-08 €bn	BOI Sep-08 €bn	Anglo Sep-08 €bn	INBS Sep-08 €bn	ILP Sep-08 €bn	EBS Sep-08 €bn
Property & construction	159.2	50.4	38.0	60.6	7.4	1.5	1.3
Total	426.5	137.6	145.1	73.7	11.9	41.5	16.7
Mortgage lending	35%	23%	44%	0%	13%	89%	89%
Other personal	5%	7%	5%	6%	6%	0%	0%
Property & Construction	37%	37%	26%	82%	62%	4%	8%
Other lending	23%	33%	25%	12%	18%	8%	3%
Total	100%	100%	100%	100%	100%	100%	100%

Table 2 (a): Total Loans Reviewed by PWC

	OirL Sep-08 €bn	Oir L Sep-08 €bn	Combined Sep-08 €bn				
Land & Development	23.7	13.1	19.7	5.6	-	0.5	62.6
Property Investment	26.7	24.9	40.9	1.8	1.5	0.8	96.6
Property backed lending	50.4	38	60.6	7.4	1.5	1.3	159.2
Other loans (non-personal)	45.6	33.4	8.9	2.2	3.2	0.5	93.8
Total Loans (ex. Personal)	96	71.4	69.5	9.6	4.7	1.8	253.0

Table 2(b): Land and Development

Unzoned	1.5	0.4	1.4	0.1	-	0	3.4
Zoned with no PP	6.6	2.8	5.2	2.1	-	0.2	16.9
Zoned with PP	3.6	2.2	3.2	0.8	-	0.2	10
Landbank	11.7	5.4	9.8	3	-	0.4	30.3
WIP/Construction	12.0	7.7	8.6	1.8	-	0.1	30.2
Other	-	-	1.3	0.8	-	-	2.1
Total Land & Development	23.7	13.1	19.7	5.6	0.0	0.5	62.6

Table 3: Capital requirements to maintain an 8% core tier 1 capital ratio

	AIB €bn	BOI €bn	Anglo €bn	INBS €bn	ILP €bn	EBS €bn	Combined €bn
Current per PCW report	2.8	2.0	1.8	-	-	-	6.6
Maximum per Merrill analysis (including PWC 2 stress testing)	5.7	2.9	4.3	0.2	-	-	13.1
Banks own assessment of needs	2	2	1.5	-	-	.2	5.7

Summary of results of Oir L valuations and comparison to land and development facilities shows that asset value reductions do not translate directly into loan impairments

Summary of Oir L Valuations

€ in millions	Oir L	Oir	OL	OL	OL
Properties Reviewed (No.)					
Land and Development	153	33	57	82	32
Investment	7	10	17	10	-
Total	160	43	74	92	32
JLL valuations					
Land and Development	6,129.1	1,710.6	2,826.8	5,178.1	125.4
Investment	773.1	663.8	1,662.2	516.7	-
Total	6,902.2	2,374.4	4,489.0	5,694.8	125.4
Bank Valuations					
Land and Development	7,929.7	2,853.5	3,861.2	7,967.0	218.1
Investment	928.0	963.6	2,059.8	624.4	-
Total	8,857.7	3,817.1	5,921.0	8,591.4	218.1
OL Discount					
Land and Development	-22.7%	-40.1%	-26.8%	-35.0%	-42.5%
Investment	-16.7%	-31.1%	-19.3%	-17.2%	N/A
Facilities					
Land and Development	7,401.7	2,238.7	3,150.1	5,927.0	206.3
Investment	924.4	820.9	1,553.8	365.4	-
Impact on Facilities:					
Effective Cross Collateral					
Land and Development	1,331.2	659.2	353.4	766.8	80.9
Investment	94.4	175.5	(128.4)	(151.3)	-
Potential Impairment Rate					
Land and Development	18.0%	29.4%	11.2%	12.9%	39.2%
Impact on Facilities: Ineffective Cross Collateral					
Land and Development	1,878.5	659.2	693.0	1,291.5	80.9
Investment	151.3	175.5	54.1	8.8	-
Potential Impairment Rate					
Land and Development	25.4%	29.4%	22.0%	21.8%	39.2%
Investment	16.4%	21.4%	3.5%	2.4%	N/A

Source: Oir reports; PwC Analysis

- The table opposite sets out a summary of the Oir L security valuations work, the bank facilities related to the Oir L sample and the potential impact on land and development and investment impairments for the five banks over the next three to five years on the basis of their being effective or ineffective cross collateralisation .
- A more detailed analysis by bank is set out in separate spreadsheets supplied to Oir L and set out at Appendix 3, *Detailed Oir Analysis*.
- The Oir L land and development property values are at a significant discount to the bank valuations ranging from 22.7% for Oir L to 40.1% for Oir L and 42.5% for Oir L . Oir L has a lower mark down because they took a “haircut” of circa 20% on valuations as part of their internal credit review as part of their year end audit process which completed recently. The other three banks have not reached that point in their annual reporting cycle yet.
- The 44.5% difference between the maximum and minimum land and development discounts becomes an 17.4% difference between banks when the valuations are compared to borrowers’ facilities on the basis that cross collateral is ineffective. This emphasises the danger in assuming there is a linear relationship between reductions in asset values and loan impairments.

Surplus estimated for OL and Oir



Another Issuance Box ticked by AIB

AIB successfully broadens funding sources

AIB issued a new benchmark senior unsecured bond yesterday. The €500m issuance was priced at a yield of 2.981% (mid swaps +235bps, ahead of initial price talk of MS+250bps). The bond is expected to be rated Ba3 by Moody's.

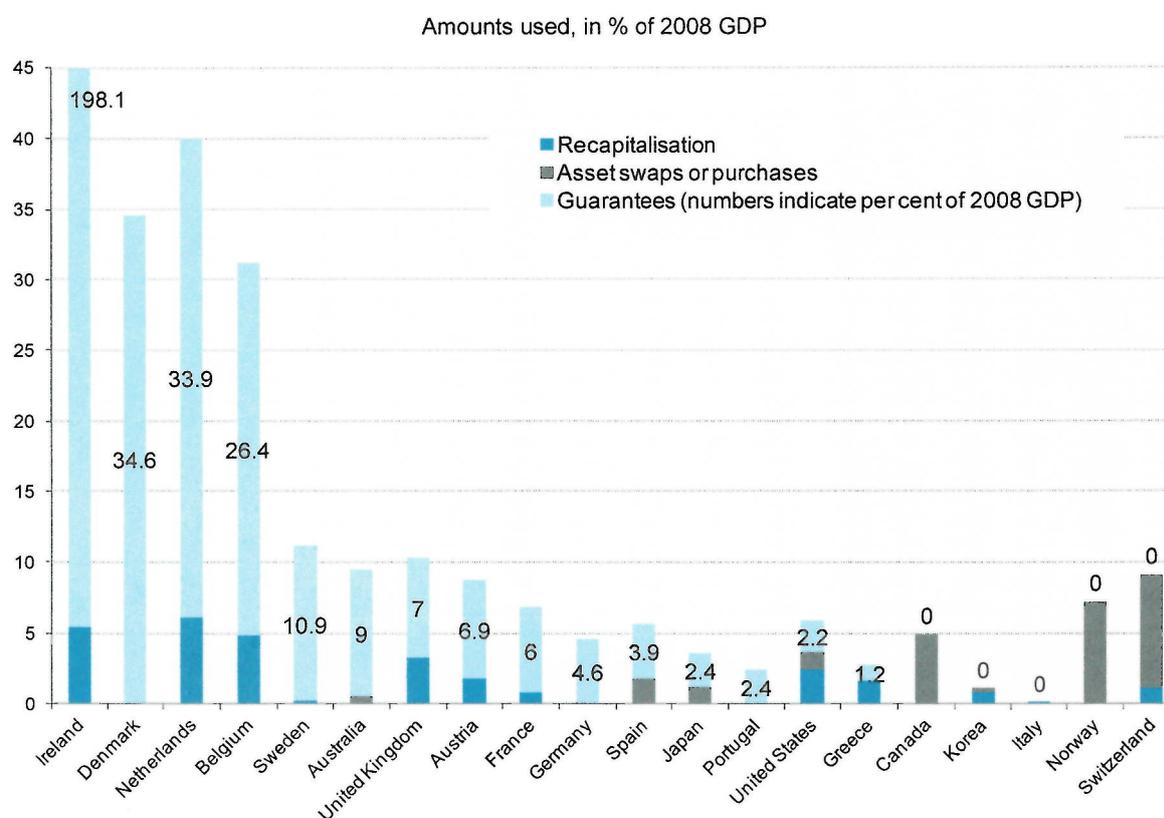
This sale represents AIB's first senior unsecured unguaranteed issuance since 2009. Prior to yesterday AIB had focused on secured funding, issuing three ACS over the past year (raising €1.5bn in the process), while earlier this month it also raised €500m in term funding secured by credit card receivables.

Recent bond issuance by the Irish 'Pillar Banks'

Announcement date	Issuer	Description	ISIN	Amount issued
13/11/2012	BKIR	3 year ACS	XS0856562524	€1,000m
28/11/2012	AIB	3 year ACS	XS0861589819	€500m
12/12/2012	BKIR	10 year T2 debt	XS0867469305	€250m
22/01/2013	AIB	3.5 year ACS	XS0880288211	€500m
15/03/2013	BKIR	5 year ACS	XS0907907140	€500m
29/05/2013	BKIR	3 year senior unsecured	XS0940658361	€500m
03/09/2013	AIB	5 year ACS	XS0969616779	€500m
25/09/2013	BKIR	7 year ACS	XS0975903112	€500m
31/10/2013	BKIR	12 year ACS (private placement)	XS0991249623	€10m
06/11/2013	BKIR	3.5 year ACS	XS0993264331	€1,000m
19/11/2013	AIB	3 year senior unsecured	XS0997144505	€500m

Despite strong demand (the final order book was in excess of six times oversubscribed), AIB elected to raise only €500m from this transaction. We were not surprised by this decision. We suspect that, as with its successful moves to rebuild its ACS curve over the past year, AIB will seek to build out its senior unsecured curve with further new issuance over the coming 12-18 months. Aside from yesterday's issuance, AIB has only two other benchmark issuance in this space, comprising the €750m bond maturing in November 2014 (XS0465876349) and the €2bn Government Guaranteed bond maturing in March 2015 (XS0496222877).

As noted above, the order book was heavily oversubscribed, with €3.6bn of demand received. More than 260 accounts were involved from 25 countries including the UK, Germany, the Nordics, France and Italy. International investors took up 99% of the final allocations.

Figure 1. Composition of financial support measures

Notes: Announced amounts in the cases of Denmark and Ireland. For Switzerland, amounts actually transferred in the case of asset swaps or purchases. In Italy, recapitalisation amounts to 0.1% and guarantees used to 0% of 2008 GDP.

Source: OECD Secretariat and Banca d'Italia estimates based on IMF (2010a).

The “division of labour” between treasuries and central banks has been effective

After the demise of Lehman Brothers and the severe tensions that paralysed financial markets in the fall of 2008, public intervention in support of the financial system was characterised by a “division of labour” between policy makers.

On the one hand, central banks have expanded liquidity provision to the banking system by widening the range of counterparties, eligible collateral and average maturity of refinancing. Some central banks enacted so-called “quantitative easing” by purchasing large amounts of government bonds. On top of this, central banks have provided support to specific market segments deemed to have systemic importance by means of outright purchases of securities: commercial paper, asset-backed commercial paper, government sponsored enterprises (GSEs) residential mortgage-based securities and GSE bonds in the United States; and covered bonds in the euro area. These forms of liquidity provision and market support have translated into a significant expansion of central bank balance sheets, as illustrated in Figure 2, which shows monetary base increases for selected central banks in Committee on Financial Markets (CMF) member jurisdictions.

A few countries account for most of the guaranteed bond issued volume

A few countries account for most of the guaranteed bond issued volume. The United States leads the league (Table 3), also reflecting the fact that US guarantees were provided by default to all banks and all bonds (up to a maximum of around 125% of bonds outstanding as of fall 2008), unless the bank explicitly opts out. Robust issuance has also been recorded in the United Kingdom, France, Germany and Australia.

Table 3. Characteristics of guaranteed bond issuance in individual countries

For the period October 2008 to May 2010

Country	Total issuance (billion euro)	Number of issuers	Number of bonds issued	Average size of each bond (billion euro)	Average maturity at issuance (months)	Percentage of available guarantees
Australia	109,5	20	311	0,4	40	(3)
Austria	20,0	6	21	1,0	38	27
Belgium	4,0	1	4	1,0	23	21 (2)
Denmark	32,2	40	177	0,2	28	(3)
France	127,6	2	77	1,7	33	48
Germany	184,1	11	47	3,9	27	46
Greece	8,5	3	6	1,4	33	30
Ireland	61,2	10	174	0,4	30	100 (2)
Luxemburg	0,7	1	2	0,3	21	16
Netherlands	47,1	6	38	1,2	46	24
New Zealand	6,0	7	22	0,3	40	(3)
Portugal	4,4	5	5	0,9	36	22
South Korea	0,9	1	2	0,5	33	1
Spain	40,3	34	95	0,4	37	40
Sweden	18,3	5	71	0,3	40	14
United Kingdom	147,3	14	165	0,9	30	54
United States	248,2	42	191	1,3	33	14

(1) Source for committed amounts: European Commission.

(2) Authorised program size not available.

Source: Estimates by OECD Secretariat and Banca d'Italia based on Bloomberg and BIS.

The United States and Spain stand out for the high number of issuing banks

As far as the number of issuers is concerned, the United States, Denmark and Spain stand out for the high number of issuing banks: in the first case this reflects the fact that all US issuing banks were expected to use the guarantees unless they opt out. In Denmark, a general guarantee was adopted in favour of all unsubordinated and unsecured debt, covering the majority of commercial banks and savings banks. In the case of Spain, the number reflects the fragmentation of the savings bank sector.

On the other hand, despite the large overall amount of issuance, relatively few German banks issued guaranteed bonds. France is a special case because, with the exception of Dexia, issuance on behalf of French banks has been carried out by the agency SFEF, which did not disclose the names of the "client" banks. The table also shows that Australia is the country with the highest number of bond issued (311), followed by the United States (191), Denmark (177), Ireland (174) and the United Kingdom (165). As for the characteristics of the issue, the average size of the bond differs significantly across countries: average size is very large in Germany (€3.8 billion), is €1.7 billion in France and around €1 billion in Austria, Belgium, Greece, the

Table 6.2 Historical compliance with the Maastricht criteria

	<i>Inflation</i> (%)	<i>Long-term</i> <i>interest rates</i> (%)	<i>Deficit</i> <i>ratio</i> (%)	<i>Debt/GDP</i> (%)	<i>ERM two-year</i> <i>membership</i>
Austria	1.1	5.6	2.5	66.1	yes
Belgium	1.4	5.7	2.1	122.2	yes
Denmark	1.9	6.2	-0.7	65.1	yes
Finland	1.3	5.9	0.9	55.8	no
France	1.2	5.5	3.0	58.0	yes
Germany	1.4	5.6	2.7	61.3	yes
Greece	5.2	9.8	4.0	108.7	no
Ireland	1.2	6.2	-0.9	66.3	yes
Italy	1.8	6.7	2.7	121.6	no
Luxembourg	1.4	5.6	-1.7	6.7	yes
Netherlands	1.8	5.5	1.4	72.1	yes
Portugal	1.8	6.2	2.5	62.0	yes
Spain	1.8	6.3	2.6	68.8	yes
Sweden	1.9	6.5	0.8	76.6	no
United Kingdom	1.8	7.0	1.9	53.4	no
1998 reference values	2.7	7.8	3.0	60.0	
Greece (2000)	2.0	6.4	1.6	104.4	yes
2000 reference values	2.4	7.2	3.0	60.0	

Source: European Commission Convergence Reports, 1998 and 2000.

severe conflict with other members. The French 'empty chair' policy and Prime Minister Thatcher's trenchant demands for a budget rebate are but two examples. Why should not the newcomers use a veto-threat to get into EMU early?

Imagine that the Estonian, Slovenians, Hungarians, Czechs, Slovaks, Latvians, Lithuanians and Poles all wanted in and had made major domestic sacrifices to make the grade. What could they do if they were refused? One can envisage all sorts of scenarios in 2005 and 2006 when the EU will be working on a new long-term budget plan ('Financial Perspective').³ According to the timeline in Figure 6.2, this is exactly when the Council will have to vote on EMU enlargement. Is it unreasonable to suggest that the newcomers might implicitly trade their vetoes over the budget to gain EMU membership?

Another scenario involves ECB reform. If the EU fails to reform the ECB before enlargement, the CEECs will have a veto over ECB reform. They might, in this case, feel perfectly justified in threatening to veto reform unless they are assured

3 The next Financial Perspective covers the period 2007–2013 and discussion on this is likely to take place between 2004 and 2006. (The 2000–2006 Financial Perspective talks started with publication of Agenda 2000 in July 1997 and continued up to the official adoption at the General Affairs Council in June 1999.)