TUARASCÁIL ón gComhchoiste Fiosrúcháin i dtaobh na Géarchéime Baincéireachta

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

REPORT of the Joint Committee of Inquiry into the Banking Crisis

Houses of the Oireachtas
(Inquiries, Privileges and Procedures) Act, 2013

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Dept. of Finance
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Appropriateness and effectiveness of the domestic policy responses

LINE OF INQUIRY: C4a

Decision to nationalise Anglo in 2009 and a review of the alternatives available and/or considered

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Commission

FYI

20 March 2009

23/03

Mr. Brian Lenihan T.D.
Minister for Finance
Government Buildings
Upper Merrion Street
Dublin 2

Proposed Purchase of Preference Shares in Allied Irish Banks plc and Bank of Ireland

Dear Minister,

I refer to your letter dated 7 March 2009 requesting that the NPRF Commission arrange appropriate legal and financial due diligence on Allied Irish Banks plc and Bank of Ireland and retain legal and other financial advisers as necessary so that you can form a judgement with respect to the probability of each bank's Core Tier 1 Capital being above the regulatory minimum at end 2011 and identify matters or issues which might reasonably be considered of a "red flag" nature. You further requested that the exercise be completed as soon as possible.

Following receipt of your letter the Commission engaged PWC and Arthur Cox to undertake financial and legal due diligence on the two banks. We also have access to Merrill Lynch, the Government's financial advisers, who are reviewing the outputs from the due diligence exercise. The Commission has retained, as a special adviser, Sir Andrew Large, former Deputy Governor of the Bank of England and former Chairman of the precursor of the FSA, the Securities and Investment Board, in the UK.

Due diligence work is underway in both banks with particular emphasis on Bank of Ireland in light of the fact that it has scheduled an extraordinary general meeting of shareholders for 27 March to vote on the issuance of the €3.5bn preference shares. It is expected that the due diligence reports on Bank of Ireland will be received on 24 March for consideration by the Commission on Wednesday, 25 March before being forwarded to you. In the meantime we have been receiving work in progress reports from PWC and Arthur Cox on the Bank of Ireland and the purpose of this letter is to brief you on the key issues emerging to date.

In summary, the rate of deterioration of Bank of Ireland's loan book, notably in property and construction, has significantly worsened, compared with expectations when PWC did their original work for the Regulator last autumn; the loan loss provisions will be significantly greater and are now more likely to be front loaded in the bank's financial years ending March 2009, 2010 and 2011. The loan loss provisions are now estimated by PWC to be in excess of €10 billion for the period to end-March 2012, compared with Oliver Wyman's worse case scenario (as estimated early 2009) of €6bn and PWC's previous worse case scenario of €9bn (as estimated late 2008). Based on the estimated provisions of €10 billion, Bank of Ireland's Core Tier 1 Capital should be in or around 5% by March 2012, compared with the bank's own internal business plan projections of around 9% and the current regulatory minimum of 4%.

The estimated outcome of 5% is subject to considerable uncertainty and is critically dependent on the economic environment; having regard to the nature of the preference shares being acquired by the State, there is a non-trivial risk that the bank will have to raise additional ordinary equity in the period under review. There is a considerable risk that after 2011, because loan losses will eliminate the bank's distributable reserves and also because of the likelihood of extremely low free cash flow, the bank will be unable to service in cash the coupons on the preference shares. As a consequence, the payment-in-kind mechanism is likely to be triggered: based on the bank's current market capitalisation of around €400m one such coupon (€280 million) paid in the form of ordinary equity would result in the State having a majority shareholding in the bank. Also based on free cash flow estimates, including those in Bank of Ireland's own business plan, it is unlikely that the €3.5 billion preference share capital will be redeemed before its fifth anniversary and that as a result the bank will have to pay the 25% premium (provided for in the terms of the preference shares) on the capital account. It should be stressed, however, that any such delay in redeeming the preference shares would not constitute an event of default.

There are three other material matters which I would like to advert to at this stage. First, the bank has a significant deficit of €1.6 billion in its staff pension funds at the present time which, under normal Pension Board rules and subject to the agreement of the trustees, would have to be eliminated over a 10 year period. In that regard we understand that the bank is considering financial measures which would include a cash contribution to the funds of €500m in either 2010 or 2011. Second, we asked PWC to look at the extent of interest roll up: we have been advised that the bank has indicated the annual roll up to be running at in excess of €400m per annum. Finally, you will be familiar with the severe liquidity pressures on the funding side of the bank's balance sheet and I do not propose to comment further.

As indicated, I expect to be in a position to let you have the outcome of the due diligence reports on Bank of Ireland immediately following the planned meeting of the Commission on Wednesday next, 25 March. Due diligence work on Allied Irish Banks plc is ongoing but, given the emerging situation in Bank of Ireland, which has a smaller balance sheet and considerably lower exposure to property and construction than AIB, it is likely that the proposed €3.5 billion preference share investment in AIB will fall short of what is required.

I am, of course, available if you wish to discuss any aspect of the due diligence exercise.

Kind regards

Yours sincerely

Paul Carty

Paul Carty
Chairman

Minister's Statement regarding Anglo Irish Bank

The Government has today decided, having consulted with the Board of Anglo Irish Bank Corporation plc ("Anglo"), to take steps that will enable the Bank to be taken into public ownership.

This decision has been taken after consultation with the Central Bank and the Financial Regulator which has confirmed that Anglo Irish Bank remains solvent.

Anglo Irish Bank is a major financial institution whose viability is of systemic importance to Ireland. Anglo has a balance sheet of some €100bn with a substantial deposit base which the State is determined to safeguard. The Government has made clear that it will ensure its continued viability. Anglo Irish Bank will continue to trade normally as a going concern, with appropriate Government support as necessary. All Anglo employees remain employed by the company.

The funding position of the bank has weakened and unacceptable practices that took place within it have caused serious reputational damage to the bank at a time when overall market sentiment towards it was negative. Accordingly the Government believes that the recapitalisation is not now the appropriate and effective means to secure its continued viability. Therefore the Government must move to the final and decisive step of public ownership.

The Government believes that the prospects for the institution are solidly underpinned in the new structure, with the benefit of state ownership and a renewed management and Board. In the current circumstances the State is the only available potential owner.

The recently appointed Chairman of the Board, Mr. Donal O'Connor, will stay on as Chairman. Anglo will be managed on an arms length basis as a commercial entity. A new Board will be appointed having regard to the need for appropriate continuity.

Shareholder rights will be respected in this process. The relevant legislation outlines a process for determining compensation as appropriate.

All customers of Anglo Irish Bank can be assured that the full amount of their deposits and savings are further safeguarded by this action. They can also be assured that they can and should continue transacting with Anglo as normal and there is no need for customers to take any steps as a result of this announcement. Anglo Irish Bank will communicate directly with all customers in the coming days.

Information will be available on the websites of Anglo Irish Bank, the Central Bank, the Financial Regulator, and the Department of Finance. Customers with particular queries may also phone Anglo Irish Bank or the Financial Regulator.

Creditors (including bondholders) of Anglo Irish Bank can be assured that it will continue to service its obligations and will repay its debts at maturity.

The Government has prepared legislation to put this decision into effect. This will be presented to the Houses of the Oireachtas on Tuesday.

Tomorrow before the markets open, it is expected that the Irish Stock Exchange and the UK Listing Authority will announce that Anglo shares will be suspended from listing on the Stock Exchanges.

The Minister said “I would again stress that this Government decision safeguards the interest of the depositors of Anglo, and the stability of the economy, given the significance of Anglo in this regard, as already recognised by the European Commission. The bank will continue to operate as normal and depositors and creditors should continue to transact as normal.”

Customers of all financial institutions can have confidence that the wider financial system in Ireland remains well capitalised and liquid and that the Irish authorities will be proactive to ensure that their interests are protected and their deposits and debts are secure.

The Government will ensure the continued viability of all systemic financial institutions.

The Government remains fully committed to the recapitalisation proposal already announced in relation to AIB and Bank of Ireland. These plans include injection of core tier 1 capital in the form of preference shares and underwriting of further core tier 1 capital issuance.

Ends

January 15, 2009

EUROPEAN COMMISSION

Brussels, 14.1.2009
C(2009) 134 final

Subject: **State aid N 9/ 2009 – Recapitalisation of the Anglo-Irish Bank by the Irish State**

Sir,

I. PROCEDURE

(1) On 21st December 2008, the Irish Government announced its intention to inject €1.5 billion (the "measure at issue") into Anglo-Irish Bank Corporation plc ("Anglo" or the "Bank") under the Irish Government's bank recapitalisation program, subject to shareholders' approval and approval by the European Commission under State aid rules. On 8th January 2009, the Irish Government formally notified to the Commission the measure at issue.

II DESCRIPTION OF THE MEASURE

1. The Beneficiary

(2) Anglo-Irish Bank has a balance sheet size in excess of €100 billion (approximately 50% of GDP) and accounts for a significant share of customer deposits and lending in the Irish economy. Anglo is a focused business bank with a private banking arm. The Bank provides business banking, treasury and wealth management services. It is not a universal bank and its stated approach is niche rather than broad market. In terms of its business model, Anglo-Irish Bank can be categorised as a "monoline" bank specialising in commercial and real estate lending. The Bank's main strategy is to lend on a senior first secured basis to clients against investments and development property assets in each of its three core markets: Ireland, the UK and the US. Each of its customers deals directly with a dedicated relationship manager and a product specialist. Lending comprises approximately 70% of the Bank's total assets of approximately €100 billion. These lending assets are split geographically as follows: 57% in Ireland, 29% in the UK and 13% in the US.

Mr Micheál Martin T.D.
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(3) Anglo has locations in Ireland, the UK, the United States, Jersey and the Isle of Man. Its shares are quoted on the Dublin and London stock exchanges. The Irish Financial Regulator is the lead regulator.

(4) Anglo-Irish Bank's funding model is heavily reliant on wholesale lending, the availability of which has diminished very substantially on account of the dislocation of international credit markets. Anglo Irish Bank has approximately […][*]of term debt maturing in 2009. Anglo Irish Bank's loan book is approximately €72 billion and it is heavily exposed to commercial investment property (c. €40 billion) and, more crucially, to the development sector (c. €20 billion).

(5) According to its preliminary results for the year ended 30th September, 2008, the Bank had a balance sheet total of €101,321 million. Anglo Irish Bank results were a profit before tax of €784 million for 2008, but included significantly increased collective and specific impairment provisions, totalling €724 million. Treasury losses account for a further €155 million impairment provision. Anglo Irish Bank reported actual impaired loans of €957 million (131 basis points of its loan book) for 2008. The market views these provisions as too conservative and the market consensus estimate is an average of 200 basis points of the Bank's loan book (€1.4 billion per annum). However, according to a report on the financial position of the six main domestic institutions participating in the Guarantee Scheme (the "PwC Report") carried out by PricewaterhouseCoopers for the Irish Financial Regulator (the "Financial Regulator"), Anglo Irish Bank's current capital position could withstand provisions substantially in excess of market estimates. Profits before impairments in 2009 are projected by Anglo Irish Bank at approximately €1.6 billion.

(6) […] the key risk currently faced by Anglo Irish Bank is liquidity risk, which the Financial Regulator is closely monitoring on a daily basis. Since the end of November 2008, Anglo Irish Bank has experienced outflows both in terms of corporate and retail deposits. Accordingly, the Bank has had to increase its level of borrowing from the interbank market […] to manage this funding gap[1].

(7) According to the Financial Regulator, Anglo Irish Bank is currently in compliance with regulatory capital requirements. Its current Tier 1 capital amounts to c. €7.2 billion, which is more than 8% of risk-weighted assets, and its Core Tier 1 capital ratio stands at 5.9%), but it is lower than many European peers. According to the Financial Regulator, Anglo Irish Bank has a strong requirement for additional Core Tier 1 capital in order to reassure the market regarding its capacity to fully provide for anticipated losses on its loan book. Market feedback is that there would be little if any private investment in an ordinary share rights issue or preference share issue by Anglo Irish Bank.

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* Covered by the obligation of professional secrecy.

1 In addition to the €1.5 billion Government injection, other measures being put in place to enhance the liquidity position of the bank going forward include the approval of an asset covered securities bank, which will increase its access to ECB borrowings, and additional undrawn committed facilities from two credit institutions.

(8) Anglo 5 Yr Senior debt CDS data are higher than the average for the sector and than any of its peers in Ireland separately for the 7th January (latest figure), 18th December 2008 (directly before the announcement of the measure by the Irish government), the average between January 2007 and August 2008 (comprising the pre-crisis period) and average between January 2008 and August 2008, as illustrated in the table below[2]:

5 Year Senior CDS (bps)

	Anglo	AIB	BoI	IL&P	Average
07-Jan-09	394	205	266	264	282
18-Dec-08	396	205	231	254	272
Average 2-Jan-08 to 31-Aug-08	248	119	136	171	169
Average 2-Jan-07 to 31-Aug-08	127	64	70	89	88

(9) As to its rating, Anglo is rated A1 by Moody's and has been on negative watch since 17 October, while S&P's A- rating was put on negative watch on 5 November this year.

2. The events triggering the Measure

(10) According to the Irish government, the decision to inject €1.5 billion into Anglo was taken in the light of the impact of the current global financial crisis on Anglo and recent corporate governance developments at Anglo. The measure at issue aims both at ensuring that the Bank's capital ratio levels meet the expectations of international investors and at facilitating lending to the real economy.

(11) Anglo is one of the financial institutions covered by the Irish Guarantee Scheme for financial institutions ("the Guarantee Scheme"), which was adopted under the Credit Institutions (Financial Support) Act, 2008 (hereafter the "Act"), and approved by the Commission under State aid Rules on 13th October, 2008. The liabilities covered under the Guarantee Scheme were those liabilities existing at close of business on 29th September, 2008 or at any time thereafter, up to and including 29th September, 2010, in respect of the following: (i) all retail and corporate deposits (to the extent not covered by existing deposit protection schemes in the State or any other jurisdiction); (ii) interbank deposits; (iii) senior unsecured debt; (iv) asset covered securities; and (v) dated subordinated debt (Lower Tier 2), excluding any intra-group borrowing and any debt due to the European Central Bank arising from Eurosystem monetary operations. It is estimated that the total covered liabilities under the Guarantee Scheme amount to approximately €65 bn.

(12) Despite its coverage under the Guarantee Scheme, market perceptions concerning the inadequacy of Anglo's capital ratio levels have led to deterioration in investor sentiment with regard to Anglo. The Bank's shares have experienced a significant deterioration in value from around €5 in early October, 2008 to the position of €0.171 on 31st December, 2008 with a market capitalisation of €129.95 million. Over the previous 12 months, the Bank traded as high as €10.94, with a market

2 Annex 7 of the Notification, Source Merrril Lunch Estimates.

capitalisation of €8,327.74 million. As a result, Anglo's shares have lost more than 98% of their value over the last 12 months.

(13) The primary objective of the Guarantee Scheme was to address the loss of confidence in interbank lending markets that led to liquidity difficulties for even fundamentally sound banks. The Guarantee Scheme was successful in stabilising the liquidity position of Anglo Irish Bank which, along with the other main banks in Ireland, was at the time at substantial risk of liquidity runs. However, the Guarantee Scheme, which addresses liquidity difficulties, is not designed to address problems with the capital adequacy of capital ratio levels of banks. The market perception of Anglo Irish Bank is that, notwithstanding increased provisioning, it has underprovided for its loan risks in the light of the significant deterioration in the property market, and the share price has fallen sharply accordingly.

(14) In addition to difficulties caused by the global financial crisis, the deterioration in the financial position of the Bank has been accelerated by difficulties that rose with regard to the corporate governance of the Bank. On 18th December, 2008, the chairman of the bank resigned, followed by the bank's non-executive director its the chief executive, because of temporary transfers of top management loans with Anglo to another bank prior to Anglo's year end over eight years. The Irish Financial Regulator has launched an inquiry into the events surrounding the corporate governance developments at Anglo and has instigated a review of the treatment of directors' loans in the financial institutions covered by the Guarantee Scheme. These events were widely commented in the Irish press.

3. The decision to intervene

(15) In these circumstances, the Irish Government, in consultation with the Governor of the Central Bank of Ireland (the "Governor") and the Financial Regulator, decided that it was necessary for the State to take measures in relation to Anglo in order to avoid further deterioration in the financial situation of the Bank, which, in turn, would represent a threat to the stability of both the financial system in the State and the wider economy. In particular, according to the Irish Government, a loss of confidence in Anglo could undermine confidence in the Irish financial sector as a whole, which is very dependant upon international finance through wholesale money markets. This would constitute a serious risk of a systemic crisis in the Irish financial system, which, in turn, would have significant negative spill-over effects into the wider economy. For these reasons, on 21st December, 2008, the Irish Government announced the decision to take the measure at issue. The main objective of the capital injection into the bank is to ensure that Anglo is adequately capitalised to preserve financial stability and to ensure that the Bank's capital ratio levels meet the expectations of international investors.

(16) A further objective pursued by the State is to facilitate lending to the real economy. The measure at issue is part of a wider Government recapitalisation programme, the object of which is to ensure that the financial system in Ireland is capitalised to meet the everyday financial needs of individuals, businesses and the overall economy. In the Government announcement on 21st December, 2008, the Minister for Finance (the "Minister") stated that "it is appropriate as part of the agreed recapitalisation programme that the banks should further build on the commitments given in the banks guarantee scheme through specific credit policies targeted at small medium enterprises, first time buyers and consumers generally.

The banks will be expected to contribute to the economy in a verifiable manner in relation to credit and in relation to the maintenance of a payments system which is socially inclusive". On account of Anglo Irish Bank's specific business model, which is specialised in commercial property lending and property development finance, not all of the elements of the agreed credit package will directly impact on Anglo Irish Bank, at least initially. However, according to the Irish Government, given the requirement to prepare a restructuring plan within a six month period as part of the recapitalisation initiative, future changes in the business model and strategic direction of Anglo Irish Bank are likely […]. Moreover, the Irish Government expects the public policy objectives underlying the decision to recapitalise systemically important banks in Ireland to guide and inform the lending activities of Anglo Irish Bank, subject, of course, to the requirement to safeguard its financial position and long-term commercial sustainability.

4. The Measure

(17) The Measure at issue is a €1.5 billion capital injection into Anglo in the form of non-cumulative perpetual preference shares. The Financial Regulator has confirmed that the Shares will be treated as Core Tier 1 Capital for regulatory capital purposes. The State investment will boost Anglo's Core Tier 1 capital ratio from 5.9% to 7.7%, and its Tier 1 capital ratio will increase from 8.4% to 10.1%.

(18) The Shares have a fixed dividend of 10% payable annually at the discretion of the Bank and in priority to dividends on ordinary shares. Dividends on the Shares are payable in cash, or if not able to pay in cash, in ordinary shares on the basis of the average daily closing price over the previous 30 trading days.

(19) The Shares are a hybrid form of Core Tier 1 capital. While they are deeply subordinated, non-cumulative and only have a discretionary dividend, they are also non-dilutive and, in relation to dividends, they rank in priority to ordinary shares. The Shares will carry 75% of the voting rights in Anglo.

(20) Redemption is at Anglo's discretion. While the Bank can repurchase the Shares at par for up to five years, after that period, Shares can be repurchased at 125% of par. Dividends on ordinary shares are not allowed where a dividend on the Shares is not paid to the State.

(21) Under the terms and conditions of the State investment, Anglo has committed to draw up and submit within six months a restructuring plan which will be submitted to the Commission for assessment and approval.

(22) The terms and conditions of the State investment also envisage management and board changes at Anglo and Government representation on the Board of Directors of the Bank.

(23) In addition, in the context of the Government's recapitalisation program, Anglo has agreed to a series of conditions in relation to sustaining lending to the real economy and the maintenance of a payments system which is socially inclusive. These conditions are focused on SMEs and individuals. They include increased capacity for lending to SMEs and first time buyers, a new code of practice for business lending and increased assistance for householders in arrears on mortgage repayments, including a commitment not to seek enforcement action or

repossession for at least six months. According to the Irish authorities, such measures do not entail any selective advantage to undertakings. In case these measures would entail elements of State aid, the Irish authorities committed to notify them to the Commission separately for assessment under the State aid rules.

(24) Finally, Anglo continues to be subject to the behavioural conditions and transparency and reporting conditions that may be imposed under paragraphs 24 to 50 of the Guarantee Scheme. In particular, Anglo Irish Bank has been required to prepare and submit a strategic report to the Department setting out how it proposes to align the future direction of the Bank to meet the objectives of the Guarantee Scheme, as well as regular reports describing the progress made in complying with these objectives. In this respect, the following measures can be mentioned:

- Board of Directors: Anglo Irish Bank has appointed two directors representative of the public interest nominated by the Minister to its board;
- Remuneration: Anglo Irish Bank has provided a plan for review by the Covered Institutions Remuneration Oversight Committee (CIROC) under the Guarantee Scheme on the proposed structure of the remuneration packages of the directors and executives of the bank so as to comply with the requirements of the Guarantee Scheme;
- Ban on dividends until further notice;
- Prohibition of buy-backs without prior approval;
- Prohibition of funding initiatives without prior consultation;
- Prior consultation in relation to public disclosures concerning its assets;
- Prohibition on advertising on the basis of the Guarantee Scheme;
- Corporate Social Responsibility arrangements;
- Controls over recourse to interbank deposits;
- Requirements for quarterly compliance certificates in relation to the terms and objectives of the Guarantee Scheme; and
- Risk management arrangements to guard against technical default under the Guarantee.

(25) The table below summarizes the terms and conditions of the State investment, including details of the instruments used:

Size	EUR 1.5 billion
Form of Security	Core Tier 1 non-cumulative preference shares with voting rights
Transferability	Non-transferable
Dividend	Fixed dividend of 10% payable, at the discretion of the bank, annually on 16 January. Dividends payable in cash. If not able to pay in cash then paid in the form of ordinary shares. Calculated on the basis of unpaid dividend divided by the share value. Share value is calculated based on the average daily closing price over the 30 trading days preceding the dividend declaration date. Payment of dividends made in priority to dividends on ordinary shares
Term	Perpetual, no step-up
Redemption	Redemption at the Bank's option Anglo can repurchase at par for 5 years and thereafter at 125% of par, subject to replacement of capital and Irish Financial Regulator approval Replacement capital needs to be Core Tier 1
Ranking	Pari passu to ordinary share capital on liquidation and with other preference shares/securities for dividends
Dividend Stopper	Yes, if cash preference share dividend is unpaid
Voting rights	Full voting rights as long as preference shares outstanding Voting rights to represent 75% of total voting rights
Other Items	Management and board change Board will have Government representation Submission of restructuring plan after six months in line with European Commission Recapitalisation Communication Sustained lending to the real economy Other behavioral, transparency and reporting conditions imposed under the guarantee scheme

(26) An Extraordinary General Meeting ("EGM") of the Bank in relation to the State investment is scheduled on 16th January, 2009 and, subject to shareholder approval at the EGM, the State investment is anticipated to take place on 20th January, 2008.

4. Position of Ireland

(27) The Irish Government notes that current global financial crisis has led to a sudden and dramatic increase in the market's perception of the risks contained in banks' balance sheets. Consequently, international capital market expectations in relation to capital levels for financial institutions have risen significantly. In particular, markets and rating agencies have increasingly focussed on the adequacy of Tier 1 capital and Core Tier 1 capital.

(28) According to the Irish Government, Anglo is a fundamentally sound institution. The decision to inject € 1.5 billion € in Anglo was taken in the light of the impact of the current global financial crisis on Anglo and recent corporate governance developments at Anglo, which together have led to a serious deterioration in the financial position of the Bank. The objectives of the State investment are to ensure that Anglo is adequately capitalised to preserve financial stability, to ensure that the Bank's capital ratio levels meet the expectations of international investors and to facilitate lending to the real economy.

(29) The Irish Government accepts that, in the current market circumstances, the State investment may contain elements of State aid. However, it is of the view that the State investment is compatible with the Common Market on the basis of Article

87(3)(b) of the EC Treaty as it is necessary in order to remedy a serious disturbance in the Irish economy.

(30) The Irish Government, together with Anglo have provided following commitments

- Anglo commits that it will refrain from mass marketing invoking the Measure as an advantage in competitive terms.

- Anglo has committed to draw up and submit within six months a restructuring plan, in the sense of the Commission's Communication on recapitalisations[3], which will be submitted to the Commission for assessment and approval.

III. ASSESSMENT

1. Existence of State Aid

(31) According to Article 87 (1) EC, State aid is any aid granted by a Member State or through state resources in any form whatsoever which distorts, or threatens to distort, competition by favouring certain undertakings, in so far as it affects trade between Member States.

(32) Given that the Anglo-Irish Bank is active in the financial sector, which is open to intense international competition, any advantage from State resources to Anglo-Irish would have the potential to affect intra-Community trade and to distort competition. This conclusion is reinforced by the fact that the activities of Anglo Irish are not confined to Ireland but that the Bank is also active in the UK, the United States, Jersey and the Isle of Man. Since the Irish Government invests € 1.5 billion € to the bank, it is also clear that the measure is imputable to the Irish State and that if any advantage is granted through the measure, State resources are involved.

(33) Finally, it has to be examined whether the measure leads to a selective advantage to Anglo Irish for it to constitute a State aid.

(34) The Irish authorities explained that, in view of the rising international capital market expectations in relation to capital levels for financial institutions and the corporate governance difficulties to which Anglo Irish was recently faced, a State intervention was necessary for the bank to reinforce its capital position.

(35) The Commission shares the view […] that, in the current market circumstances and given its situation Anglo Irish could not have raised such financing in such time frame at comparable conditions. This view is reinforced by the fact that public policy considerations, and in particular the willingness to avoid a further deterioration in Anglo's financial position which would represent a threat to the stability of the financial system and to increase lending to the real economy, have determined the State intervention, rather than the possible return for the State as an investor.

[3] Commission Communication on "The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition", adopted on 05.12.2008, available on: http://ec.europa.eu/competition/state_aid/legislation/specific_rules.html#financial

(36) The Commission therefore comes to the conclusion that the measure provides a selective advantage to Anglo and that it constitutes State aid in the sense of Article 87(1) EC.

2. Compatibility of the aid with the common market

Compatibility under 87(3)(b) EC Treaty

(37) Article 87(3)(b) EC Treaty enables the Commission to declare aid compatible with the Common Market if it is "to remedy a serious disturbance in the economy of a Member State. The Commission recalls that the Court of First Instance has stressed that Article 87(3)(b) EC Treaty needs to be applied restrictively and must tackle a disturbance in the entire economy of a Member State[4].

Conditions for compatibility under Article 87(3)(b) of the EC Treaty

(38) In line with the Commission Communication on "The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis" ("the Communication on the financial crisis")[5], in order for an aid or aid scheme to be compatible under Article 87(3)(b) EC Treaty, it must comply with general criteria for compatibility under Article 87(3) EC Treaty, viewed in the light of the general objectives of the Treaty and in particular Articles 3(1)(g) and 4(2), which imply compliance with the following conditions[6]:

a. *Appropriateness*: The aid has to be well targeted in order to be able to effectively achieve the objective of remedying a serious disturbance in the economy. This would not be the case if the measure is not appropriate to remedy the disturbance.

b. *Necessity*: The aid measure must, in its amount and form, be necessary to achieve the objective. That implies that it must be of the minimum amount necessary to reach the objective, and take the form most appropriate to remedy the disturbance. In other words, if a lesser amount of aid or a measure in a less distortive form (e.g. a temporary and limited guarantee instead of a capital injection) were sufficient to remedy a serious disturbance in the entire economy, the measures in question would not be necessary. This is confirmed by settled case law of the Court of Justice.[7]

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[4] Cf. in principle case Joined Cases T-132/96 and T-143/96 Freistaat Sachsen and Volkswagen AG Commission [1999] ECR II-3663, para. 167. Confirmed in Commission Decision in case C 47/1996, Crédit Lyonnais, OJ 1998 L 221/28, point 10.1, Commission Decision in Case C28/2002 Bankgesellschaft Berlin, OJ 2005 L 116, page 1, points 153 et seq and Commission Decision in Case C50/2006 BAWAG, OJ L 83 of 26.3.2008, point 166. See Commission Decision of 5 December 2007 in case NN 70/2007, Northern Rock, OJ C 43 of 16.2.2008, p. 1, Commission Decision of 30 April 2008 in case NN 25/2008, Rescue aid to WestLB, OJ C 189 of 26.7.2008, p. 3, Commission Decision of 4 June 2008 in Case C9/2008 SachsenLB, not yet published.

[5] Commission Communication on "The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis", adopted on 13.10.2008, OJ C 270 of 25.10.2008, pages 8–14.

[6] Cf. Commission decision of 10 October 2008 in case NN 51/2008 *Guarantee scheme for banks in Denmark*, OJ C 273 of 28.10.2008, at point 41.

[7] Cf. Case 730/79, *Philip Morris* [1980] ECR 2671. This line of authority has recently been reaffirmed by the Court of Justice in. Case C-390/06, *Nuova Agricast v Ministero delle Attività Produttive* of 15 April 2008, where the Court held that, "As is clear from Case 730/79 […], aid which improves the financial situation of the recipient undertaking without being necessary for the

c. *Proportionality*: The positive effects of the measures must be properly balanced against the distortions of competition, in order for the distortions to be limited to the minimum necessary to reach the measures' objectives. This follows from Article 3 (1) g EC Treaty and Article 4 (1) and (2) EC Treaty, which provide that the Community shall ensure the proper functioning of an internal market with free competition. Therefore, Article 87 (1) EC Treaty prohibits all selective public measures that are capable of distorting trade between Member States. Any derogation under Article 87(3)(b) EC Treaty which authorises State aid must ensure that such aid must be limited to that necessary to achieve its stated objective.

(39) The fourth chapter of the Communication on the financial crisis[8], as well as the Communication on recapitalisations[9], then translate these general principles into conditions specific for recapitalisation schemes. The principles contained therein apply *mutatis mutandis* also to individual cases. In the next paragraphs, the Commission will therefore assess the compatibility of the notified measure with these criteria.

Appropriateness of the measure to remedying a serious disturbance in the economy

(40) Following the introduction of the Guarantee Scheme, the Irish authorities commissioned PricewaterhouseCoopers to prepare a report on the financial position of the institutions participating in the Guarantee Scheme (the “PwC Report”). The PwC Report concluded that the capital positions of each of the institutions reviewed, including Anglo, was in excess of regulatory requirements as of 30th September, 2008 and that, under a number of stress scenarios, capital levels in each of the institutions will remain above regulatory minimum levels in the period to 2011. The Central Bank and Financial Regulator also shares the view that Anglo Irish Bank is currently fully in compliance with regulatory capital requirements.

(41) However a letter from the Governor of the Central Bank of Ireland and Financial Regulator to the Minister dated 18th November, 2008 summarising and commenting on the conclusions of the PwC Report indicates that […]. On that basis and bearing in mind the volatility of the economic and financial environment the Board of the Central Bank and the Financial Services Authority of Ireland support the measure at issue which aims at strengthening the capital position of Anglo Irish bank.

(42) The Commission acknowledges that rising international capital market expectations in relation to capital levels for financial institutions, in the context of the current crisis, can make it necessary also for banks that meet the regulatory solvency ratios to further strengthen their capital ratios.

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attainment of the objectives specified in Article 87(3) EC cannot be considered compatible with the common market […]."

8 Commission Communication on "The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis", adopted on 13.10.2008, OJ C 270 of 25.10.2008, pages 8–14.

9 Commission Communication on "The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition", adopted on 05.12.2008, available on: http://ec.europa.eu/competition/state_aid/legislation/specific_rules.html#financial

(43) In the present market circumstances, it is doubtful whether Anglo could have raised this capital on the private market. Indeed, despite its coverage under the Guarantee Scheme, market perceptions concerning the inadequacy of its capital ratio levels have led to deterioration in investor sentiment with regard to Anglo. The Bank's shares have experienced a significant deterioration in value from around €5 in early October, 2008 to the position of €0.171 on 31st December, 2008 with a market capitalisation of €129.95 million. Over the previous 12 months, the Bank traded as high as €10.94, with a market capitalisation of €8,327.74 million. As a result, Anglo's shares have lost more than 98% of their value over the last 12 months.

(44) As to its rating, Anglo is rated A1 by Moody's and has been on negative watch since 17 October, S&P's A- rating was put on negative watch on 5 November last year.

(45) In addition to difficulties caused by the global financial crisis, the deterioration in the financial position of the Bank has been accelerated by difficulties with regard to its corporate governance (see § 9 above).

(46) Anglo's funding model is heavily reliant on wholesale lending, the availability of which has diminished very substantially on account of the dislocation of international credit markets. Anglo Irish Bank has approximately […]of term debt maturing in 2009. Anglo Irish Bank's loan book is approximately €72 billion and it is heavily exposed to commercial investment property (c. €40 billion) and, more crucially, to the development sector (c. €20 billion).

(47) Moreover, while Anglo Irish Bank results were a profit before tax of €784 million for 2008, they included significantly increased collective and specific impairment provisions, totalling €724 million. Treasury losses account for a further €155 million impairment provision. Anglo Irish Bank reported actual impaired loans of €957 million (131 basis points of its loan book) for 2008. The market views these provisions as too conservative and the market consensus estimate is an average of 200 basis points of the Bank's loan book (€1.4 billion per annum).

(48) In these circumstances, the Irish Government, in consultation with the Governor of the Central Bank of Ireland (the "Governor") and the Financial Regulator, decided that it was necessary for the State to take measures in relation to Anglo in order to avoid further deterioration in the financial situation of the Bank, which, in turn, would represent a threat to the stability of both the financial system in the State and the wider economy.

(49) Indeed, Anglo Irish Bank is one of the six core banks in the State. Anglo Irish Bank has a balance sheet size in excess of €100 billion (approximately 50% of GDP) and accounts for a significant share of customer deposits and lending in the Irish economy.

(50) Further deterioration in Anglo's financial position could represent a threat to the stability of both the financial system in the State and the wider economy. In this respect, it is important to note that the Irish financial sector is very dependant upon international finance through wholesale money markets. Therefore, a loss of confidence in Anglo could undermine confidence in the Irish financial sector as a whole, thus entailing a serious risk of a systemic crisis in the Irish financial system, with significant negative spill-over effects into the wider economy. In a

letter dated 8th January, 2009, the Governor has confirmed the systemic importance of Anglo Irish Bank to maintaining the stability of the financial system in the State.

(51) Therefore, the Commission considers that a public sector capital intervention in Anglo Irish is a necessary and appropriate means to strengthen the bank's capital base with the aim of restoring market confidence in the Irish financial sector, thus avoiding the risk of a serious disturbance of the entire Irish economy.

Limitation of the aid to the strict necessary

(52) Capital interventions must be done on terms that minimise the amount of aid. This relates to the amount of the measure as well as to the conditions at which it is provided.

(53) As regards the total amount of the recapitalisation, the injection of €1.5 billion represents 1,75% of risk weighted assets of the bank[10]. The measure will help the Anglo-Irish Bank to improve its core Tier 1 capital ratio from 5,9 to 7,7% and its tier 1 capital ratio from 8,4 to 10,1%. The Commission notes that the size of the recapitalisation in terms of proportion of risk-weighted assets of the bank remains below the indicator of the Communication on recapitalisation of banks[11], and levels of capitalisation reached after the State intervention are in line with previous Commission decisions[12].

(54) The Commission also notes that the State guarantee on the balance sheet of the Anglo-Irish Bank, in line with the Commission decision approving the Irish guarantee scheme for banks[13], has not proved sufficient in the above market and bank-specific circumstances (as shown in particular by market share collapse exacerbated by corporate governance problems), and needed to be supplemented by strengthening the bank's capital base.

(55) Taking the above into account, the Commission is satisfied that this capital injection of €1.5 billion is the minimum necessary to remedy concerns about the stability of the Anglo-Irish Bank and thus the Irish financial system.

(56) As regards the remuneration of the measure, the Commission acknowledges that setting the remuneration as high as the current clearing levels would restrain the financial institutions from using such measures. Moreover, it is the Commission's

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10 According to its preliminary results for the year ended 30th September, 2008, the Bank had a balance sheet total of €101,321 million.

11 See the reference to a positive evaluation by the Commission of a capital injection that would not exceed 2% of the banks' risk weighted assets, cf. Annex to the Commission Communication on "The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition", C(2008) 8259 final, of 05.12.2008.

12 See, for example, Commission decision of 18.12.2008 in case N 602/2008 *KBC* Belgium, where the core Tier 1 capital ratio increased to 8.2% and Tier 1 to 10.7% following State recapitalization, the Commission decision of 10.12.2008 in case N 611/2008 SNS Reaal, where the Tier 1 capital ratio of SNS Bank NV increased to 10%, or the Commission decision of 13.11.2008 in case N528/2008 *ING* NL, where the Tier 1 ratio increased to 10% after recapitalization.

13 Commission decision of 13.10.2008 in case NN 48/2008, *Guarantee scheme for banks in Ireland*.

intention to adjust to long term market conditions and not to impose the current unfavourable conditions on the financial institutions today.

(57) In its Communication on recapitalisations, the Commission accepts as a minimum remuneration based on the Eurosystem methodology of 20 November 2008. This methodology takes account of the banks' risk profile and involves the calculation of a price corridor with an average required rate of return of 7% on preferred shares with features similar to those of subordinated debt and an average required rate of return of 9,3% on ordinary shares relating to Euro area banks[14]. The Communication distinguishes between fundamentally sound banks, for which the methodology above applies and distressed banks, for which remuneration should normally be higher.

(58) In the case at hand, in line with the Communication on recapitalisations, the Commission must take into account the type of capital provided and the risk profile of the bank in order to evaluating the adequacy of the State capital remuneration, the Commission.

(59) As far as the bank's risk profile is concerned, the following indicators are relevant (see the annex to the Communication): capital adequacy, size of recapitalisation, current CDS spreads, current rating of the bank and its outlook.

(60) In this context, the Commission notes positively the relatively small size of the recapitalisation, i.e. below 2% of the bank's risk weighted assets, the fact that the bank meets regulatory capital ratio requirements, and the PwC report' finding that the bank could maintain them even under a number of stress scenarios.

(61) However, the Commission also notes the letter from the Central Bank and Financial Regulator to the Minister dated 18th November, 2008 indicating that […]. The Commission also notes that this study is (at this stage) not complemented by an assessment of the prospective capital adequacy of the bank by the Financial Regulator or other evaluation of the bank's exposure to various risks (such as credit risk, liquidity risk, market risk, interest rate and exchange rate risks), the quality of the asset portfolio, the sustainability of its business model in the long term and other pertinent elements, in line with the Recapitalisation Communication.

(62) Also the risk profile of the bank, as revealed by its CDS spreads and ratings, is relatively high (see §8 above). Its riskiness, as measured by the CDS spreads on 5 years senior debt, is perceived by the markets above those of its Irish peers and stays well above the average for the European banking sector. For example, Itraxx index for the period 10.9.2007 till 10.10.2008 reveals an average CDS spread on 5 year senior debt for EU banks of 74 b.p., while it reaches 243 b.p. on average for Anglo for the period 10.9.2007 till 10.9.2008[15]. The levels preceding the current crisis are lower but even the low values at the beginning of the period for Anglo are still above the sector average (60 b.p. for Anglo on 17.10.2007 while sector low for the period was 20 on 15.10.2007).

[14] See the application of this methodology in the recent Commission decisions of 10.12.2008 in the case N 611/2008 *Aid to SNS REAAL N.V.* and of 18.12.2008 in case N 602/2008 *KBC* Belgium.

[15] Source: Bloomberg, Itraxx financials CDS series 8

(63) Finally, Anglo is rated A1 by Moody's and has been on negative watch since 17 October. S&P's A- rating was put on negative watch on 5 November this year.

(64) As to the type of capital provided, the Commission notes that in the case at hand, the instruments that will be used to make the State investment are non-cumulative perpetual preference shares in the Bank with voting rights. The Shares are a hybrid form of Core Tier 1 capital. While they are deeply subordinated, non-cumulative and only have a discretionary dividend, they are also non-dilutive and, in relation to dividends, they rank in priority to ordinary shares.

(65) As regards the overall position of the State in relation to its investment in the bank, the Commission notes positively that the capital injection will give the State 75% of voting rights in the company. The Commission also notes that the probability of return for the State through dividends increases through a combination of their payment in cash or ordinary shares.

(66) On the basis of the above the Commission does not share the view of the Irish authorities that the bank remains fundamentally sound. However, given the size of the capital injection, the specific characteristics of the Shares, and the banks' risk profile as outlined above, the Commission finds that a discretionary remuneration of 10% per annum, which is above the minimum price corridor for fundamentally sound banks, is consistent with the Recapitalisation Communication.

(67) In line with the Communication on recapitalisations, it is also necessary to ensure that there are sufficient incentives to redeem the State participation when the market will so allow. In the case at hand, such incentive provided through the level of remuneration is further complemented by redemption clauses. While redemption is at Anglo's discretion and the Bank can repurchase the Shares at par for up to five years, after that period, shares can be repurchased at 125% of par. This provides an incentive for Anglo to redeem the Shares during the initial five year period. In addition, replacement capital must be Core Tier 1, which should ensure that the State investment is replaced with private equity investment in Anglo.

(68) Moreover, there is a restrictive dividend policy while the State holds the shares: dividends on ordinary shares are not allowed where a dividend on the shares is not paid to the State. This encourages the Bank to redeem the State capital injection as soon as possible, while also providing the Bank with the flexibility to incentivise private equity investment through the payment of dividends on ordinary shares where a dividend is paid to the State on the Shares.

(69) In the case at hand, the Commission considers that the terms and conditions of the State investment, together with the terms and conditions already imposed on Anglo under the Guarantee Scheme, contain safeguards against possible abuses and distortions of competition (see §24 above). In particular, the Commission views positively the commitment of the bank to refrain from mass marketing of the measure.

(70) Finally, the Commission considers that the submission of a restructuring plan is needed to secure the proportionality of the aid and to limit possible distortions of competition. It notes that the Irish authorities have committed to notify a restructuring plan of the Anglo-Irish Bank within 6 months.

(71) In view of the corporate governance difficulties to which the bank was recently faced, the Commission further notes positively the management and board changes imposed on the bank, the fact that the Board will have Government representation and the voting rights attached to the State's preferred shares.

3. Conclusion

(72) Therefore, the Commission can conclude that the measure conforms to the conditions laid down in the Communication on the financial crisis and the Communication on recapitalisations.

IV. DECISION

(73) The Commission comes to the conclusion that the provision of capital by the Republic of Ireland in the conditions described above constitutes State aid pursuant to Article 87(1) EC Treaty.

(74) The Commission considers that this measure fulfils the conditions to be considered compatible with the Common Market pursuant to Article 87(3)(b) EC Treaty. Consequently, the Commission raises no objection against the notified aid and authorizes it as emergency intervention in the face of the current financial crisis for a period of 6 months.

(75) The Commission takes note of Ireland's commitment to notify a restructuring plan to the Commission within six months from the recapitalisation[16].

If this letter contains confidential information which should not be published, please inform the Commission within fifteen working days of the date of receipt. If the Commission does not receive a reasoned request by that deadline, you will be deemed to agree to publication of the full text of this letter to agree to the disclosure to third parties and to the publication of the full text of the letter in the authentic language on the Internet site.
http://ec.europa.eu/community_law/state_aids/index.htm.

[16] In line with the requirements under point 44 of the Commission Communication on recapitalizations.

Your request should be sent by registered letter or fax to:

- European Commission
  Directorate-General for Competition
  State aid Greffe
  Rue de la Loi/Wetstraat, 200
  B-1049 Brussels
  Fax No: (+32)-2-296.12.42

Yours faithfully,

For the Commission

Neelie KROES
Member of the Commission

Appendix 1:

Bacon Report on Options for Resolving Property Loan Impairments and Associated Capital Adequacy of Irish Credit Institutions

Overview:

The Bacon report identifies and seeks to address two critical issues:

1. That the lack of market confidence in Irish banks - reflected in low share prices and funding outflows despite the guarantee - is founded on uncertainty about the adequacy of capital levels in the banks to meet future loan impairments.
2. That a large part of the increase in sovereign borrowing costs is based on market uncertainty around the State's exposure to the c. €440bn contingent liability assumed with the guarantee of all bank liabilities.

Bacon recommends the establishment of a National Asset Management Agency (NAMA) to take over and manage all the Land and Development loans and Investment Property loans currently held by the covered banks, totalling some €158bn. These assets would be mandatorily purchased by the State, at discounted rates to their original book values, by the issue of c.€124bn worth of Government bonds to the banks. A further €7.5bn recapitalisation of the covered institutions, the sale or controlled winding down of a merged Anglo-INBS entity, and a review of the guarantee Scheme, also form part of Mr. Bacon's proposals.

This approach would address market uncertainty around future capital levels in the banks. This should allow the banks to raise and retain funding, and lend to the economy. In addition, subject to the agreement of the ECB, the banks could use the Government bonds to access c. €118bn in funding from the ECB, thereby addressing current liquidity constraints in the Irish system.

The proposal would involve a sharp increase in the level of national debt (from 41% to 111% of GDP). However, the definitive transfer of all risky bank assets to the State, would bring certainty to the market on the Government's borrowing requirement to address the banking crisis (c.€130bn rather than c.€440bn). Returns from the assets held by the NAMA would accrue to the State. As the assets transferred would be discounted and would include both performing and non-performing loans, the State could expect to recover, over time, at least the greater part of the cost of acquiring these assets.

Summary:

1. Crisis in Irish Banking:

The expansion of credit in recent years has been funded by growth in external funding sources of the banks. The downturn in the economy has brought a lack of market confidence in the ability of the banks to cover losses arising from the credit they extended, which has resulted in funding outflows of €45bn to date in 2009, and a consequent deterioration in the day-to-day liquidity positions of the banks.

It is estimated that between now and 2011, the six covered institutions face a cumulative impairment on their property-related loan exposures of around €34bn, or

20% of the total value of the property loans outstanding at September 2008 of €158.3bn. Of this loss, €20bn relates to land and development lending, and €14bn relates to lending for property investment. These figures are based on the assumption of a 55% peak-to-trough decline in the value of development assets, and a 32% reduction in the value of investment assets, and are broken down as follows:

Projected impairment of Development & Investment Property loans (€bn):

Total	AIB	Anglo	BoI	INBS	IL&P	EBS
34	10.8	12.9	7.6	2.2	0.2	0.3

Using these estimates, retaining the 6 banks' capital levels at above 7.5% in the absence of a transfer of risky assets to the State, would require a further recapitalisation of the banks of €8.4bn, as follows:

Projected <u>additional</u> capital required to raise Tier1 Capital Ratio to 7.5% following projected impairment (€bn):

Total	AIB	Anglo	BoI	INBS	IL&P	EBS
8.4	1.5	5.6	-	1.0	-	0.3

However, because of continuing market uncertainty around eventual losses on the risky assets, even if this projected capital requirement was met by the State, the banks would retain their current 'zombie' status, with depressed share prices, no prospect of private capital-raising, under continued funding pressure and consequently with no capacity to grow lending, thus hindering economic recovery. In addition, market concerns around the sovereign exposure to the banks under the guarantee would remain, complicating further the required adjustment of the public finances and leaving Ireland's international credit rating subject to downward pressures and speculative attacks. Bacon suggests therefore that additional measures need to be undertaken to place the banking system on a sound footing.

2. Constraints on the Public Finances:

From a high of almost 100% of GDP in the early 1990s, national debt stood at 41% of GDP at end 2008, well below the EU average of 61% of GDP. As a result, debt servicing costs reduced from 25% of tax revenue in 1991, to 3.8% in 2008.

However, in 2008, with the widening deficit, there has been a very sharp rise in the relative cost of Government debt issuance in recent times. In the past five months, the interest rate charged for Irish 5-year bonds has trebled, to 280bps (or 2.8%) higher than the rate for German Bunds of similar maturity. Similarly, the credit default swap (CDS) rate on Irish bonds - representing the cost of insuring against default - which had been similar to that of Germany for much of the decade to date, began to increase dramatically from the third quarter of 2008 and now exceeds that for Greece, previously the country with the highest CDS rate in the EU.

In part at least, the deterioration in Ireland's relative cost of funds is related to the contingent liabilities of €440Bn assumed by the Government in respect of banks and credit institutions deposit guarantees. These were taken on from 30 September, and it is from around that date that credit spreads have deteriorated most sharply.

In determining the price to charge for Irish Government borrowing, Capital markets are simply adding contingent liabilities assumed under the guarantee to the State's outstanding debt and its prospective debt as a result of the widening deficit. In effect the sovereign debt rating is being intertwined with the country's banking problems via the guarantee on bank liabilities.

Uncertainty has been created because of the contingent nature of the bank guarantee and it is evident to market participants that credit institutions' deposits have not been stable since the guarantee was put in place. Hence, the probability of the guarantee being called has been raised. At the same time the underlying cause of instability in banks' funding: the question of the capital adequacy of the credit institutions to meet prospective impairments, remains unresolved. In these circumstances the likelihood is that the uncertainty premium in yield being attached to government debt will continue and indeed may increase, as economic conditions deteriorate.

In this context, it is imperative that initiatives should be undertaken that will lead to stability in banks deposit and term debt liabilities and eliminate the need for a renewal of the guarantee. To achieve this requires removing all doubts about capital adequacy of the credit institutions and their capacity to deal with prospective loan impairments.

3. Dealing with Loan Losses:
The report considers three options for tackling the related market uncertainties around capital levels in the banks, and the extent of liability of the State.

<u>A. Recapitalisation:</u>
Building on the assessment above on likely impairment rates, future capital shortage is anticipated by testing the adequacy of current capital in stress scenarios. In current market conditions the only realistic source of capital for the banks is the State. The report notes that where Government is guaranteeing the liabilities of the banks and has injected capital to cover losses on loans, nationalisation may be the most effective means of protecting the interest of all stakeholders.

<u>B. Asset Guarantee:</u>
Under this option, the State guarantees the level of future losses on certain (risky) bank assets. The assets remain on the balance sheet of the bank and the banks commit to covering losses on these assets up to a certain 'first loss' amount. There is no upfront cost to the State and the banks pay a fee or premium for this cover.

<u>C. Asset Purchase:</u>
In this scenario, risky assets are transferred from the bank at an agreed price. The State would have to fund the asset purchase, via the issue of Government bonds to the banks, which would negatively affect the fiscal position. The bank takes a loss on the sale and recognises this up front in its profit and loss account. The bank is then effectively cleansed of these risky assets.

The report considers the merits of asset guarantee versus assets purchase:

	Pro	**Con**
Asset Guarantee	• No upfront cost to State • Earns premium • Risk sharing provides banks	• While risk is partially transferred, assets remain on the banks' balance sheets,

	with incentive to manage loans	creating continuing uncertainty for investors around the banks positions • Creates a further contingent liability for the State •
Asset Purchase	• Banks are cleansed of troubled assets • Earns net income after financing cost • Loss sharing, since the bank has to write off the difference between the book value and the purchase price • Position for investors in the banks is made clear • State gains control over asset management	• Large upfront cost, involving increase in national debt • Losses accruing to banks would result in requirement for a further recapitalisation to maintain CT1 levels above 7.5% • Downside risk on assets accrues to State

While the asset guarantee approach has the initial attraction of having no upfront cost to the State, the approach would be subject to the same issues already encountered with the guarantee of bank liabilities: Capital markets have not grappled well with the uncertainty involved with the contingent liabilities assumed by the State and have priced Irish sovereign debt unfavourably as a result.

A further guarantee approach, this time in respect of banks' property related loan assets, would create a further layer of uncertainty through the creation of another contingent liability on the Exchequer. This would further entwine the sovereign rating with Irish banks capital adequacy problems without actually providing any clarity as to how capital adequacy would be achieved, other than through a calling of the contingent liability. By contrast the asset sales approach, while involving the recognition of 'pain' at the outset has the merit of certainty and clarity, provided the projection of the extent of impairment is accurate.

Also, an Asset Management Agency (NAMA) would offer prospects for avoiding many of the shortcomings associated with a continuation of the existing bank-property developer relationship. Potential advantages include: (i) economies of scale in administering workouts (since workouts require specialized, and often scarce, skills) and in forming and selling portfolios of assets, (ii) benefits from the granting of special powers to the government agency to expedite loan resolution and (iii) the interposing of a disinterested third party between bankers and clients, which might break "crony capitalist" connections that otherwise impede efficient transfers of assets from powerful enterprises. The latter may seem particularly beneficial in circumstances markets, where ownership concentration and connections between borrower and banks are often very close.

The NAMA would have the potential to attract potential to attract long term capital to invest in the assets taken on to achieve higher values by working out the projects rather than disposing of the assets.

The up-front losses that would accrue to the banks under the proposed asset purchase approach (€158bn of assets purchased for €124bn) would require additional recapitalisation to maintain the banks'Core Tier 1 capital ratios at 7.5%, of:

Total	AIB	Anglo	BOI	INBS	ILP	EBS
16.25	5.0	8.5	0.75	1.5	0.0	0.5

To minimise the costs to the State, consolidation of rump of INBS and Anglo (after the asset purchase transaction) to be sold to highest bidder as a business franchise, or wound downs as liabilities mature is recommended. An additional capital injection of c.€2bn would be required from the State to stabilise the (combined) institutions and maintain a Core Tier 1 capital level of around 5%. This approach would leave a requirement for further State capital provision in the banking sector, of around €7.5bn.

The impact on AIB and BoI of a further re-capitalisation as proposed would (depending on the precise terms of the investment) raise the degree of State ownership in these institutions to 90% and 85% respectively. In consequence most of the pre-impairment earnings of these institutions would accrue to the State. However there is a distinction between this position and fully nationalised entities that - similar to the situation now applying to RBS in the UK - in that both banks would retain their stock exchange listings. Therefore as market conditions improve, there will be a natural exist mechanism available for the Government to divest itself of majority ownership should it wish to.

In all circumstances it is imperative that agreement of the ECB to funding a bond of face value of €124bn would be procured before any decision is taken by Government to proceed with the recommended approach.

4. Proposal for a National Asset Management Agency:
Functions to be carried out by a NAMA comprise:

- Management and control of the assets transferred to it;
- Employment/outsourcing whatever resources required to carry out its functions efficiently and professionally;
- As it will control a large segment of the market, it should be able to regulate against further market failure due to oversupply in the future;
- It will carry no previous baggage and will have a single objective - to maximise value over a given period;
- It will not have any other banking functions or aspirations;
- It will not favour any institution or client over another, but can make decisions with the advantage of an overview which individual banks cannot have;
- It will have well marked out procedures to prevent fraud but will encourage a suitable commercial posture;

It is proposed that the NAMA be constituted via an extension of the remit of the NTMA because of the Agency's international reputation, and core expertise and technical know how. The NAMA initiative would require new legislation to establish the NAMA and define its remit, including:

- Provision of powers to price and effect transfers of relevant assets
- Definition of assets eligible for transfer

- Obligation on the banks to co-operate in relevant aspects
- Provision for an Assessor to ensure the constitutionality of the transfers

The NAMA legislation should also provide for mandatory transfer of eligible assets from the banks because a voluntary approach would be slow, prone to breakdown, and would raise difficulties in terms of the pricing of assets. A failure to provide absolute clarity to markets in relation to the timing and terms of the asset transfer could prove fatal to the initiative, and mandatory transfer is therefore recommended.

In relation to valuation of assets, a first valuation would be done by the NAMA prior to transfer, following expedited due diligence. An assessor structure would subsequently follow at a suitable time to ensure that the amount paid was fair.

Income producing assets would have the prospect of being written down to a level where the income (in aggregate and with some headroom) would pay interest and yield a profit. Non-income producing assets could be transferred on the basis of current market value of the underlying security, a 'normalised' value of the security, or an across-the-board discount of the assets of x cents in the Euro. In the later case, the transferring institution could have equity (or other exposure) to the NAMA proportionate to the "value" of the assets transferred.

One way to overcome the difficulties of pricing assets would be for the transferring banks, to provide warrants for the purchase of shares in the bank which can be exercised by the Government in several years time at a price, which depend inversely on the value of the impaired debt at that future date. The future date would need to be set far enough into the future for the market in these kinds of assets to have settled down and their price less imponderable.

The NAMA could be capitalised by:
- Credit-enhanced Bond without a Government Guarantee:
Under this approach the NAMA would issue a bond to the six covered institutions in an amount sufficient to cover the value of the transferred assets. The credit quality of the bond would depend on the equity in the balance sheet of the NAMA. The greater the equity, the lower the exposure of the bondholders to the impaired loans. The principal disadvantage is that the transfer of risk from the banks is only partial, to the extent of equity in the balance sheet of the NAMA. As to the provision of equity, it is unlikely that private equity would participate without the presence of State equity, on say a 50:50 basis. However, there are indications that private equity would be interested to participate in acquisitions of bank property portfolios. The advantage of this approach is that it limits the Exchequer's exposure to funding the transfer of the loans to NAMA, to the extent required to adequately supplement private equity participation.

- Credit bond with a Government Guarantee:
The advantage of this approach is that the bond would be eligible collateral for the purpose of Repo agreements at the Euopean Central Bank and this could be used by the banks to replenish liquidity. The disadvantage is that it would add €123.9Bn to the national debt.

The impact of such an increase in the national debt is difficult to predict. A lot of negative news has already been priced in the State's relative cost of borrowing, so it could not be concluded that funding cost would deteriorate in line with the increase in indebtedness. A key question would be whether the overall NAMA initiative was considered by capital markets to resolve the banks' capital adequacy requirements, and the associated attrition in Irish banks' deposit funding. Another key factor relates to the underlying public finance position and current efforts towards stabilising the deficit. Also, the fact that the proposed debt issuance would only be undertaken with the support of the ECB, would tend to mitigate adverse speculative reaction. There remains the risk however, that the market may focus solely on the headline news, pushing cost of borrowing wider, unless the strategic plan is explained comprehensively and clearly.

In relation to the type of Government bond that could be supplied, while the initial attraction could be to supply an instrument with low Exchequer cash outlays (non-interest bearing bullet bond with long maturity), this would adversely affect income streams and profitability in the banks, and market perceptions around the intentions and capabilities of the State to honour the bond. It is concluded that the most effective approach is to inject a type of bond which is more in line with the sort of asset which a bank would voluntarily hold on its balance sheet: short-term, and with interest rate floating in line with the market. Such an instrument can more easily be made marketable, thereby freeing the bank to move forward with an asset-side strategy that is not dependent on its particular failure history.

The cost of servicing a marketable bond of c. €120bn would be c.€2.1bn per annum. It is calculated - on the basis of €100bn of investment property assets being transferred to the AMC - that even allowing for a high level of impairment of these assets, the cash flows generated would be sufficient to ensure no net burden in terms of additional service costs.

Business Model of the NAMA:
In relation to the various categories of assets taken on, NAMA will be charged with their management in terms of disposal, holding, consolidating and creation of joint ventures for maximising return on the assets. In order to discharge the functions, NAMA will need to establish or source functional competence in: Legal; Project Finance; Project management; Planning and Design (external); Sales & Marketing (external).

Review of the Guarantee Scheme:
It is recommended that the Guarantee of bank liabilities be restructured to:
- extend the Guarantee to cover future longer term bond issuance;
- remove dated subordinated debt (Lower Tier 2), asset covered securities, and senior unsecured debt maturing beyond the 29 Sep 2010, from coverage of the guarantee, because the covered institutions get no benefit from the guarantee of these types of liabilities;
- change some of the commercial conduct provisions to enhance supervisory powers;
- make technical amendments to clarify certain issues raised by the market.

SECRET
Offig an Aire Airgeadais

Ref No **Date: 15 January 2009**

Decision Sought on the Nationalisation of Anglo Irish Bank

1. Decision Sought

The Minister for Finance asks the Government today to approve:

(a) That Anglo Irish bank should be nationalised and that this should be done by way of a Bill, the indicative text of which is attached; this will be subject to amendment to be agreed between the Minister for Finance and the Attorney General. The Bill, when finalised, is to be published.

(b) That the Houses of the Oireachtas be recalled with a view to sitting on Tuesday 20 January, with a view to taking all stages on Tuesday.

(c) That there be an early signature motion to incorporate the Bill.

(d) That the Government notes that it would be the intention of the Minister that the newly appointed Chairman and the public interest Directors would be reappointed after nationalisation and that the Minister would consider the position of the other Directors giving due regard to the need for continuity.

(e) That a statement will be issued this evening and the draft of the Bill will be made available publicly.

(f) Finally, the Minister will be informing the opposition spokespersons.

2. Background

Last night, the Central Bank, the Financial Regulator, the NTMA, and the Department of Finance recommended that nationalisation of Anglo Irish Bank provides the better prospect of stability in the Irish banking system and should be pursued in preference to the planned recapitalisation of Anglo on Friday.

This morning AIB and BOI gave their view that a nationalisation of Anglo should not de-stabilise their position, provided a clear distinction is made between their financial and market position, and that of Anglo, and each bank said that in their opinion, on balance, nationalisation was the best option available.

This advice was given because of a number of serious corporate governance concerns at Anglo, and because of Anglo's progressively deteriorating liquidity position.

3. **Corporate Governance**
There is continuing concern about governance issues including Directors loans, loans to buy Anglo shares and other financial arrangements in the Bank. The ODCE has commenced an investigation and it is possible that the ODCE would appoint a court inspector on these and other company law matters.

The Financial Regulator is concerned about all of the governance issues and is conducting a number of investigations. However, the disclosure of some or all of these issues would have the effect of further destabilising the position of Anglo Irish Bank. This is in a context where, following the resignations of the Chair and CEO, market confidence in Anglo is already extremely low, which has meant that Anglo is encountering increasing liquidity difficulties.

4. **Liquidity**
Anglo's liquidity has disimproved since early December, with the bank losing €3bn in corporate deposits. Anglo's liquidity position is now very fragile.

Fitch's are expected to downgrade Anglo's credit-rating today, leading to a potential further €1bn -€2bn outflow of corporate deposits. Downgrades from S&P are also expected to result in even greater corporate outflows. A total of €6bn or more could flow out from Anglo and it is clear that this flow is not being stemmed by our announcement on recapitalisation and government voting rights in Anglo.

Using Central Bank and NTMA options to replace this liquidity would put at risk a disproportionate amount of liquidity reserves to protect Anglo. It is considered unlikely that this public liquidity support could be repaid in the foreseeable future by the bank.

As a result of these new developments, it is necessary to re-evaluate the approach to be taken with Anglo. The alternative to the planned recapitalisation is nationalisation. While neither option can quickly resolve Anglo's difficulties, on balance nationalisation mitigates the risks that the Anglo now presents to the public finances and to financial stability.

5. **Pros and Cons of Nationalisation**
<u>Pros:</u>
- Should mitigate the risk of an S&P ratings downgrade
- Minimises deposit outflows
- Reduces risks of significant demands on the liquidity reserves available to the NTMA and the CBFSAI
- Introduces certainty in the market on Anglo
- €1.5bn can be used for liquidity funding, with a better chance of recovery
- Even with recapitalisation and liquidity support, continuing bad news could lead to a requirement to nationalise Anglo, but from a weaker position
- De-listing ends share speculation about the bank on the market
- Allows for orderly work-out of the loan book
- Allows Minister direct control to deal with the governance issues

Cons:

- Introduces perception of confused approach to Anglo problems
- Contagion risk to other banks
- Liquidity support likely to still be required
- May be perceived as a reaction to significant negative issues arising from the due diligence process
- Asset realisation values may be negatively impacted

6. Taking all of the above factors into account, I am therefore seeking your approval to nationalise Anglo Irish Bank.

THEME: C4

Appropriateness and effectiveness of the domestic policy responses

LINE OF INQUIRY: C4b

Establishment, operation and effectiveness of National Asset Management Agency (NAMA)

OIFIG AN AIRE AIRGEADAIS

Ref No: **March 2009**

SECRET

Memo for Government

Proposal for a National Asset Management Agency

1. Decision Sought

The Minister for Finance requests the Government to note:

- the summary of the report from Mr. Peter Bacon acting as the Minister's adviser to the NTMA which is given at Appendix 1;
- the liquidity support arrangement as set out in paragraph 10 and the initial conclusions of a review of the banks guarantee scheme, as set out in this Memorandum and the further Appendices.

The Minister for Finance asks the Government to note that he is working on a proposal as follows:-

- he will announce on Budget Day that he intends to set up a National Asset Management Agency (NAMA) under the auspices of the National Treasury Management Agency
- that NAMA will purchase the land and development books of the six main covered institutions and the loans of the 22 largest borrowers from these institutions; this purchase will be at a discount, will be of the order of €60bn and will be funded by the issue of Government Bonds.

The Minister for Finance asks the Government to note that there is a consensus among his advisers in favour of the establishment of a National Asset Management Agency, although there is considerable further work needed on the detail before the Budget Day announcement and that the Minister will return to Government on this issue. It will also be necessary to consult the Commission and the ECB on this matter.

2. Background

At present Irish banks face an extremely unstable outlook. In recent times they have experienced major withdrawals of deposits and established credit lines leading to substantial recourse to the Central Bank for short-term liquidity support. This is not a sustainable trend and if it persists would be expected to lead to a serious systemic issue for the Irish banking system over the coming weeks. According to some projections the six guaranteed credit institutions face cumulative economic impairment on their property loan exposures to 2011 of around €34bn, or 20 per cent of the total value of property loans of €158bn; this is before account is taken of offsetting earnings.

The initiatives taken to date by Government have been insufficient to encourage the retention of liquidity in the Irish banking system. Share values have remained depressed, deposits are continuing to fall and access to debt capital markets is very restricted. This is undermining banks' capacity to grow lending, now in the future, in support of the recovery of the real economy. The Bacon report concludes that, unless there is a restructuring, even a very considerable additional capital injection, over and above the €7bn recently announced, would do no more than maintain the banks in their current 'zombie' status till 2011 and leave Ireland's international credit rating subject to downward pressures and speculative attacks. Therefore additional and far reaching measures need to be undertaken, as soon as possible to seek to place the banking system on a sound footing.

The deterioration in Ireland's credit terms associated with the national fiscal position has been compounded by the additional contingent liabilities of c.€440bn under the bank guarantee scheme and the fact that deposits and access to international credit markets have not been stabilised as a result of the Guarantee is compounding the perception that the contingent liabilities could be realised through a bank default which would impact very severely on the State's financial position and creditworthiness.

Bacon concludes that, to achieve stability in banks deposit and term debt liabilities, doubts about capital adequacy of the credit institutions and their capacity to deal with prospective loan impairment must be removed. Additional supports should focus on the asset impairment issue and associated implications for capital adequacy.

3. Options Available to Government

There are a number of options available to Government in dealing with the current liquidity difficulties and the overall threat to the stability of the Irish banking system.

Maintain Status Quo: This option is to continue with the present recapitalisation strategy and not to undertake additional measures on the basis that they run the risk of further undermining the State's fiscal position and international credit rating. In the current circumstances, there is no apparent benefit to doing nothing. Not acting now increases the risk of a sovereign default and threatens the stability of the banks. Moreover it will not address the current liquidity shortage or promote vital lending into the economy.

Insurance: The State could establish an insurance scheme for certain assets, such as the land and development portfolio valued at €60bn. The State could then provide insurance to the banks against the majority of the losses they incur on the relevant loans above a certain "first loss" position (for example, 20 per cent.). The loans would remain on the books of the Bank who would continue to manage them over time. It is also likely that the banks would be required to share a proportion of the losses above that first loss amount (perhaps another 10 per cent. of all amounts covered by the insurance) to incentivise them to achieve the best recovery for the loans. The banks will pay a relatively small fee of c2.5% to the State for providing the insurance. The main benefit to the insurance scheme is that there is no upfront cost. However, the success of the insurance scheme depends on the market's faith in the Government's ability to cover future losses. The contingent liability element of the insurance scheme parallels the bank guarantee scheme and provides no direct method to deal with the current severe liquidity problems faced by the covered institutions who have lost over €43bn since the start of 2009. It also fails to create a strong incentive for the banks to work out their impaired loan book once their first loss has been incurred.

Asset Management Agency: An Asset Management Agency could be established. The agency would purchase a portfolio of loans from the banks focusing on the riskiest loans. The purchase could be done by issuing government bonds to the banks. The Agency would then manage the loan assets over time to ensure the minimum loss for the State. This option would be expected to cleanse the balance sheets of the banks, considerably reducing uncertainty over bad debts and allowing them to increase lending to the real economy. It would also address the liquidity difficulties the banks face as Government bonds could be used as collateral to access ECB funds. On the downside there would be a very considerable upfront cost to the State impacting the Government debt and instantly inflating the debt with related implications which are discussed elsewhere. There would also be significant logistical implications to taking this course of action. As with the risk insurance option the markets will be required to maintain faith in the Government's ability to maintain its own position. It would also be important to ensure this is consistent with the EU framework in order to maintain Ireland's capacity to work closely with the EU and our Eurozone partners as we seek to resolve the financial crisis.

A more detailed assessment of these options is at Appendix 2

4. Bacon favours an Asset Management Agency

The key conclusion in the Bacon report is that an Asset Management Agency should be established to take over the banks' Land and Development books of **c€63.5bn**.

The Bacon report however goes further and recommends that the banks commercial property books should also be taken over bringing the total value of the assets to be managed to **€158.3bn,** although these would be purchased by the State at a discount. While the report does not provide a detailed rationalisation for the extension of the assets to be purchased by the State to the banks commercial property books, Mr. Bacon did advise at an oral briefing that he was taken aback at the pace of decline in the performance of the commercial property books and had concluded that these loans must be removed from the banks to ensure the creation of clean banks which will again be in a position to lend into the economy.

Economic impairment of the combined property books to 2012 is estimated at **€34bn**. Bacon recommends this amount be written off immediately by the banks and that consequently the cost to the State of taking the property books into the Asset Management Agency will be in the region of **€120bn**. Immediate write offs on this scale will give rise to further capital investments and bank restructuring, as considered below.

The report recommends that the asset management agency be located in NTMA and funded by means of an exchange of assets; the banks would receive Government paper in return for the loan books they hand over.

5. Consensus in favour of asset management over risk insurance solution

The Bacon report has been considered by the Department, the Central Bank, the Financial Regulator, NTMA and Merrill Lynch. While the risk insurance has certain attractions in terms of deferring realisation of the impairments and funding requirements of the insurance, there is a consensus that the asset management agency is preferable as it would:

- Deal with the issue of impaired property loans more decisively and definitively, providing the banks with cleaner balance sheets and reducing the risk of further impact of impairments from property loans on the banks
- Improve the funding position of the banks by providing them with assets that can be used to access ECB funding
- Remove management of the problem loans from the banks, which should provide greater control of the work-out of the loans, address public suspicion regarding the relationships between the banks and developers and deal with market concerns that the banks are not realistic about the extent of likely losses
- The asset manager should have limited regulatory capital requirements in respect of losses on impaired loans and can manage the assets without the focus on impairment disclosure that the banks face
- Should improve sentiment towards the banks and represent the start of the repositioned investment case. It would allow management time to be refocused on rebuilding strength particularly in core retail businesses and maintaining their deposit bases, during an extended period during which it will be very challenging to raise funding.

6. The scale and cost of assets to be transferred

While there is a strong argument in favour of the creation of an Asset Management Company it is not clear that this should include all of the commercial property books of the banks as recommended by Bacon.

There are three identifiable options for what assets could be purchased by the Asset Management Agency. These are:-

i. All land and development and property development loans as recommended by Bacon – these are currently valued at c€160bn but Bacon envisages that the Asset Management Agency would pay circa €120bn for this total loan portfolio, with the banks writing off the balance of 25%;

ii. Land and Development loans only, which is the riskiest part of the banks loan portfolio – these are currently valued at c€60bn but it is envisaged that the Asst Management Agency would take these at considerable discount to the book value, perhaps of the order of 33%, and would cost circa €40bn;

iii. Land and development loans plus a certain portion of the commercial loan book (following a risk assessment to incorporate the largest exposures in the system and other risk assessment criteria) – this portfolio would amount to circa €85bn, but again there would be significant discount and would cost circa €60bn.

7. **Impact on National Debt**

The main disadvantage of the Asset Management Agency is the up front impact it will have on the national debt. At the end of 2008 the General Government Debt stood at €76.1bn (inclusive of Exchequer cash balances of €21bn) which was equivalent to 40.6% of GDP. The addendum to the Irish Stability Programme Update, presented to the Commission last January, provided for a further decline in the fiscal position in 2009. Taking account of the recent €2bn adjustment, and before supplementary measures to be decided in the coming weeks, it provided for a General Government Deficit of €17.2bn in 2009 and an increase in the debt/GNP ratio to 52.7%.

The Asset Management Agency proposal will significantly increase the level of the General Government Debt, unless a mechanism can be found to put it "off balance sheet". The scale of the impact will be determined by the amount of the banks assets transferred and the price paid for those assets. Based on the figures recently contained in the Stability Programme Update for 2009, the three options set out above would have the following impact on the level of General Government Debt in 2009:

	Stability Programme Update position	All land & development and commercial property loans (Option i)	All land & development loans only (Option ii)	All land & development loans plus a portion of the commercial loan book (Option iii)
Book value of loans (€bn)	-	160	60	85
Assumed price paid by the AMA for the loans (€bn)	-	120	40	60
General Government Debt (GGD) level (€bn)	94.7	214.7	134.7	154.7
GGD/GDP ratio (%)	**52.7**	**119.4**	**74.9**	**86.1**

The above GGD/GDP ratios would compare with an EU average of 59.8% and 104% for Italy, the highest in the EU. (2008 position in each case). Consideration will be given to whether there are structures which allow these liabilities to be kept off the GGD, but of course the markets will look through these.

8. Consensus in favour of scaled back option

The consensus view of the Central Bank, Financial Regulator, NTMA and Merrill Lynch is that the 'scaled back' option which would see the transfer of the land and development books of c€60bn, plus a certain portion of the commercial loan book, amounting to around €25bn, would be the one that provides the best balance between the objectives of stabilising the banking system while seeking to constrain the impact on the national debt.

9. Implications of creating an Asset Management Agency

With regard to the banks the implication of the transfer of a large part of their loan portfolios will see the operations of Anglo Irish Bank and INBS significantly scaled back. The option of selling on INBS remaining interests would have to be looked at after the relevant assets were removed. Anglo would either have to be recapitalised and reoriented or sold.

Further recapitalisation may also be required. The 'scaled back' asset transfer option above is based on a projected economic impairment estimate for the six institutions combined property development and part of the investment book of €25bn now. The effect of realising this kind of shortfall would require further capital injections, over and above the €7bn already announced for AIB and Bank of Ireland. It is estimated that AIB would require a further recapitalisation of about €1.5bn with €0.2bn required by EBS. Bank of Ireland would not require any further capital, over and above that already agreed.

Balance sheets at Appendix 3 indicate the aggregate impact on the six banks, the Asset Management Agency and on the State.

10. Immediate Liquidity needs.

Neither the 'status quo' nor the risk insurance options provide the banks with further access to ECB liquidity. The Asset Management Agency option does provide Government bonds which can be repo-ed at the ECB to replace lost liquidity. However, an AMA would take time to set up, so some interim liquidity support may be necessary. A short term Collateralised Lending Scheme (CLS) could be provided to the bank as a 'bridge' to the AMA. Under this scheme the NTMA and Central Bank would swap (new) short term government bonds for loans provided by the banks. These bonds could then be used as collateral with the ECB. A summary of the draft CLS scheme is provided in Appendix 4. This scheme would add to the Government debt as the banks needed liquidity. In the event that the risk insurance or status quo options were pursued, it is likely that a CLS scheme will have to be put in place also as an alternative to special liquidity facilities provided by the Central Bank to institutions that have exhausted their ECB collateral. However, it is not clear how the Government would exit such a scheme in these cases.

11. Review of the Bank Guarantee Scheme

A review of the Guarantee is currently underway, as required by the European Commission and the terms of the Guarantee Scheme itself, with the purpose of establishing whether the Guarantee continues to assist in achieving the objectives of the Credit Institutions (Financial Support) Act of 2008. While the Guarantee had a successful short-term impact, several long-term deficiencies have been identified including in particular that as demonstrated by recent liquidity outflows the Guarantee has lost credibility in the market. The Government has already agreed to seek the extension of the Guarantee to encompass longer-term bond issuance (up to five years) to support the banks in accessing longer-term funding. This would be consistent with the common EU framework. The possibility of enhancing the credibility of the Guarantee by reducing the contingent liability assumed by the State is also being examined. There are several instruments covered by the Guaranteed that have not practical benefits for the banks in supporting their funding but impact on the size of the Guarantee (e.g. covered bonds,). Very careful examination would however be required of the possible impact of a restructuring in the Guarantee on Ireland's international reputation and creditworthiness. An update on the review of the Guarantee is included at Appendix 5.

12. EU implications

The Bacon proposal would raise a number of significant issues in light of the Commission's recent Communication on the Treatment of Impaired Assets, including the assessment of assets eligible for transfer to the asset management agency, the valuation process and methodology and consistency with the sustainability of Ireland's overall fiscal position. The Commission has confirmed this in an initial response to the Bacon proposal, which identifies several issues that would need to be discussed and addressed, and the process that would need to be followed in a review of these issues. These issues are noted at Appendix 6.

Appendix 1:

Bacon Report on Options for Resolving Property Loan Impairments and Associated Capital Adequacy of Irish Credit Institutions

Overview:

The Bacon report identifies and seeks to address two critical issues:

1. That the lack of market confidence in Irish banks - reflected in low share prices and funding outflows despite the guarantee - is founded on uncertainty about the adequacy of capital levels in the banks to meet future loan impairments.
2. That a large part of the increase in sovereign borrowing costs is based on market uncertainty around the State's exposure to the c. €440bn contingent liability assumed with the guarantee of all bank liabilities.

Bacon recommends the establishment of a National Asset Management Agency (NAMA) to take over and manage all the Land and Development loans and Investment Property loans currently held by the covered banks, totalling some €158bn. These assets would be mandatorily purchased by the State, at discounted rates to their original book values, by the issue of c.€124bn worth of Government bonds to the banks. A further €7.5bn recapitalisation of the covered institutions, the sale or controlled winding down of a merged Anglo-INBS entity, and a review of the guarantee Scheme, also form part of Mr. Bacon's proposals.

This approach would address market uncertainty around future capital levels in the banks. This should allow the banks to raise and retain funding, and lend to the economy. In addition, subject to the agreement of the ECB, the banks could use the Government bonds to access c. €118bn in funding from the ECB, thereby addressing current liquidity constraints in the Irish system.

The proposal would involve a sharp increase in the level of national debt (from 41% to 111% of GDP). However, the definitive transfer of all risky bank assets to the State, would bring certainty to the market on the Government's borrowing requirement to address the banking crisis (c.€130bn rather than c.€440bn). Returns from the assets held by the NAMA would accrue to the State. As the assets transferred would be discounted and would include both performing and non-performing loans, the State could expect to recover, over time, at least the greater part of the cost of acquiring these assets.

Summary:

1. Crisis in Irish Banking:

The expansion of credit in recent years has been funded by growth in external funding sources of the banks. The downturn in the economy has brought a lack of market confidence in the ability of the banks to cover losses arising from the credit they extended, which has resulted in funding outflows of €45bn to date in 2009, and a consequent deterioration in the day-to-day liquidity positions of the banks.

It is estimated that between now and 2011, the six covered institutions face a cumulative impairment on their property-related loan exposures of around €34bn, or

20% of the total value of the property loans outstanding at September 2008 of €158.3bn. Of this loss, €20bn relates to land and development lending, and €14bn relates to lending for property investment. These figures are based on the assumption of a 55% peak-to-trough decline in the value of development assets, and a 32% reduction in the value of investment assets, and are broken down as follows:

Projected impairment of Development & Investment Property loans (€bn):

Total	AIB	Anglo	BoI	INBS	IL&P	EBS
34	10.8	12.9	7.6	2.2	0.2	0.3

Using these estimates, retaining the 6 banks' capital levels at above 7.5% in the absence of a transfer of risky assets to the State, would require a further recapitalisation of the banks of €8.4bn, as follows:

Projected <u>additional</u> capital required to raise Tier1 Capital Ratio to 7.5% following projected impairment (€bn):

Total	AIB	Anglo	BoI	INBS	IL&P	EBS
8.4	1.5	5.6	-	1.0	-	0.3

However, because of continuing market uncertainty around eventual losses on the risky assets, even if this projected capital requirement was met by the State, the banks would retain their current 'zombie' status, with depressed share prices, no prospect of private capital-raising, under continued funding pressure and consequently with no capacity to grow lending, thus hindering economic recovery. In addition, market concerns around the sovereign exposure to the banks under the guarantee would remain, complicating further the required adjustment of the public finances and leaving Ireland's international credit rating subject to downward pressures and speculative attacks. Bacon suggests therefore that additional measures need to be undertaken to place the banking system on a sound footing.

2. Constraints on the Public Finances:

From a high of almost 100% of GDP in the early 1990s, national debt stood at 41% of GDP at end 2008, well below the EU average of 61% of GDP. As a result, debt servicing costs reduced from 25% of tax revenue in 1991, to 3.8% in 2008.

However, in 2008, with the widening deficit, there has been a very sharp rise in the relative cost of Government debt issuance in recent times. In the past five months, the interest rate charged for Irish 5-year bonds has trebled, to 280bps (or 2.8%) higher than the rate for German Bunds of similar maturity. Similarly, the credit default swap (CDS) rate on Irish bonds - representing the cost of insuring against default - which had been similar to that of Germany for much of the decade to date, began to increase dramatically from the third quarter of 2008 and now exceeds that for Greece, previously the country with the highest CDS rate in the EU.

In part at least, the deterioration in Ireland's relative cost of funds is related to the contingent liabilities of €440Bn assumed by the Government in respect of banks and credit institutions deposit guarantees. These were taken on from 30 September, and it is from around that date that credit spreads have deteriorated most sharply.

In determining the price to charge for Irish Government borrowing, Capital markets are simply adding contingent liabilities assumed under the guarantee to the State's outstanding debt and its prospective debt as a result of the widening deficit. In effect the sovereign debt rating is being intertwined with the country's banking problems via the guarantee on bank liabilities.

Uncertainty has been created because of the contingent nature of the bank guarantee and it is evident to market participants that credit institutions' deposits have not been stable since the guarantee was put in place. Hence, the probability of the guarantee being called has been raised. At the same time the underlying cause of instability in banks' funding: the question of the capital adequacy of the credit institutions to meet prospective impairments, remains unresolved. In these circumstances the likelihood is that the uncertainty premium in yield being attached to government debt will continue and indeed may increase, as economic conditions deteriorate.

In this context, it is imperative that initiatives should be undertaken that will lead to stability in banks deposit and term debt liabilities and eliminate the need for a renewal of the guarantee. To achieve this requires removing all doubts about capital adequacy of the credit institutions and their capacity to deal with prospective loan impairments.

3. Dealing with Loan Losses:
The report considers three options for tackling the related market uncertainties around capital levels in the banks, and the extent of liability of the State.

A. Recapitalisation:
Building on the assessment above on likely impairment rates, future capital shortage is anticipated by testing the adequacy of current capital in stress scenarios. In current market conditions the only realistic source of capital for the banks is the State. The report notes that where Government is guaranteeing the liabilities of the banks and has injected capital to cover losses on loans, nationalisation may be the most effective means of protecting the interest of all stakeholders.

B. Asset Guarantee:
Under this option, the State guarantees the level of future losses on certain (risky) bank assets. The assets remain on the balance sheet of the bank and the banks commit to covering losses on these assets up to a certain 'first loss' amount. There is no upfront cost to the State and the banks pay a fee or premium for this cover.

C. Asset Purchase:
In this scenario, risky assets are transferred from the bank at an agreed price. The State would have to fund the asset purchase, via the issue of Government bonds to the banks, which would negatively affect the fiscal position. The bank takes a loss on the sale and recognises this up front in its profit and loss account. The bank is then effectively cleansed of these risky assets.

The report considers the merits of asset guarantee versus assets purchase:

	Pro	**Con**
Asset Guarantee	• No upfront cost to State • Earns premium • Risk sharing provides banks	• While risk is partially transferred, assets remain on the banks' balance sheets,

	with incentive to manage loans	creating continuing uncertainty for investors around the banks positions • Creates a further contingent liability for the State •
Asset Purchase	• Banks are cleansed of troubled assets • Earns net income after financing cost • Loss sharing, since the bank has to write off the difference between the book value and the purchase price • Position for investors in the banks is made clear • State gains control over asset management	• Large upfront cost, involving increase in national debt • Losses accruing to banks would result in requirement for a further recapitalisation to maintain CT1 levels above 7.5% • Downside risk on assets accrues to State

While the asset guarantee approach has the initial attraction of having no upfront cost to the State, the approach would be subject to the same issues already encountered with the guarantee of bank liabilities: Capital markets have not grappled well with the uncertainty involved with the contingent liabilities assumed by the State and have priced Irish sovereign debt unfavourably as a result.

A further guarantee approach, this time in respect of banks' property related loan assets, would create a further layer of uncertainty through the creation of another contingent liability on the Exchequer. This would further entwine the sovereign rating with Irish banks capital adequacy problems without actually providing any clarity as to how capital adequacy would be achieved, other than through a calling of the contingent liability. By contrast the asset sales approach, while involving the recognition of 'pain' at the outset has the merit of certainty and clarity, provided the projection of the extent of impairment is accurate.

Also, an Asset Management Agency (NAMA) would offer prospects for avoiding many of the shortcomings associated with a continuation of the existing bank-property developer relationship. Potential advantages include: (i) economies of scale in administering workouts (since workouts require specialized, and often scarce, skills) and in forming and selling portfolios of assets, (ii) benefits from the granting of special powers to the government agency to expedite loan resolution and (iii) the interposing of a disinterested third party between bankers and clients, which might break "crony capitalist" connections that otherwise impede efficient transfers of assets from powerful enterprises. The latter may seem particularly beneficial in circumstances markets, where ownership concentration and connections between borrower and banks are often very close.

The NAMA would have the potential to attract potential to attract long term capital to invest in the assets taken on to achieve higher values by working out the projects rather than disposing of the assets.

The up-front losses that would accrue to the banks under the proposed asset purchase approach (€158bn of assets purchased for €124bn) would require additional recapitalisation to maintain the banks'Core Tier 1 capital ratios at 7.5%, of:

Total	AIB	Anglo	BOI	INBS	ILP	EBS
16.25	5.0	8.5	0.75	1.5	0.0	0.5

To minimise the costs to the State, consolidation of rump of INBS and Anglo (after the asset purchase transaction) to be sold to highest bidder as a business franchise, or wound downs as liabilities mature is recommended. An additional capital injection of c.€2bn would be required from the State to stabilise the (combined) institutions and maintain a Core Tier 1 capital level of around 5%. This approach would leave a requirement for further State capital provision in the banking sector, of around €7.5bn.

The impact on AIB and BoI of a further re-capitalisation as proposed would (depending on the precise terms of the investment) raise the degree of State ownership in these institutions to 90% and 85% respectively. In consequence most of the pre-impairment earnings of these institutions would accrue to the State. However there is a distinction between this position and fully nationalised entities that - similar to the situation now applying to RBS in the UK - in that both banks would retain their stock exchange listings. Therefore as market conditions improve, there will be a natural exist mechanism available for the Government to divest itself of majority ownership should it wish to.

In all circumstances it is imperative that agreement of the ECB to funding a bond of face value of €124bn would be procured before any decision is taken by Government to proceed with the recommended approach.

4. Proposal for a National Asset Management Agency:

Functions to be carried out by a NAMA comprise:

- Management and control of the assets transferred to it;
- Employment/outsourcing whatever resources required to carry out its functions efficiently and professionally;
- As it will control a large segment of the market, it should be able to regulate against further market failure due to oversupply in the future;
- It will carry no previous baggage and will have a single objective - to maximise value over a given period;
- It will not have any other banking functions or aspirations;
- It will not favour any institution or client over another, but can make decisions with the advantage of an overview which individual banks cannot have;
- It will have well marked out procedures to prevent fraud but will encourage a suitable commercial posture;

It is proposed that the NAMA be constituted via an extension of the remit of the NTMA because of the Agency's international reputation, and core expertise and technical know how. The NAMA initiative would require new legislation to establish the NAMA and define its remit, including:

- Provision of powers to price and effect transfers of relevant assets
- Definition of assets eligible for transfer

- Obligation on the banks to co-operate in relevant aspects
- Provision for an Assessor to ensure the constitutionality of the transfers

The NAMA legislation should also provide for mandatory transfer of eligible assets from the banks because a voluntary approach would be slow, prone to breakdown, and would raise difficulties in terms of the pricing of assets. A failure to provide absolute clarity to markets in relation to the timing and terms of the asset transfer could prove fatal to the initiative, and mandatory transfer is therefore recommended.

In relation to valuation of assets, a first valuation would be done by the NAMA prior to transfer, following expedited due diligence. An assessor structure would subsequently follow at a suitable time to ensure that the amount paid was fair.

Income producing assets would have the prospect of being written down to a level where the income (in aggregate and with some headroom) would pay interest and yield a profit. Non-income producing assets could be transferred on the basis of current market value of the underlying security, a 'normalised' value of the security, or an across-the-board discount of the assets of x cents in the Euro. In the later case, the transferring institution could have equity (or other exposure) to the NAMA proportionate to the "value" of the assets transferred.

One way to overcome the difficulties of pricing assets would be for the transferring banks, to provide warrants for the purchase of shares in the bank which can be exercised by the Government in several years time at a price, which depend inversely on the value of the impaired debt at that future date. The future date would need to be set far enough into the future for the market in these kinds of assets to have settled down and their price less imponderable.

The NAMA could be capitalised by:
- Credit-enhanced Bond without a Government Guarantee:
Under this approach the NAMA would issue a bond to the six covered institutions in an amount sufficient to cover the value of the transferred assets. The credit quality of the bond would depend on the equity in the balance sheet of the NAMA. The greater the equity, the lower the exposure of the bondholders to the impaired loans. The principal disadvantage is that the transfer of risk from the banks is only partial, to the extent of equity in the balance sheet of the NAMA. As to the provision of equity, it is unlikely that private equity would participate without the presence of State equity, on say a 50:50 basis. However, there are indications that private equity would be interested to participate in acquisitions of bank property portfolios. The advantage of this approach is that it limits the Exchequer's exposure to funding the transfer of the loans to NAMA, to the extent required to adequately supplement private equity participation.

- Credit bond with a Government Guarantee:
The advantage of this approach is that the bond would be eligible collateral for the purpose of Repo agreements at the Euopean Central Bank and this could be used by the banks to replenish liquidity. The disadvantage is that it would add €123.9Bn to the national debt.

The impact of such an increase in the national debt is difficult to predict. A lot of negative news has already been priced in the State's relative cost of borrowing, so it could not be concluded that funding cost would deteriorate in line with the increase in indebtedness. A key question would be whether the overall NAMA initiative was considered by capital markets to resolve the banks' capital adequacy requirements, and the associated attrition in Irish banks' deposit funding. Another key factor relates to the underlying public finance position and current efforts towards stabilising the deficit. Also, the fact that the proposed debt issuance would only be undertaken with the support of the ECB, would tend to mitigate adverse speculative reaction. There remains the risk however, that the market may focus solely on the headline news, pushing cost of borrowing wider, unless the strategic plan is explained comprehensively and clearly.

In relation to the type of Government bond that could be supplied, while the initial attraction could be to supply an instrument with low Exchequer cash outlays (non-interest bearing bullet bond with long maturity), this would adversely affect income streams and profitability in the banks, and market perceptions around the intentions and capabilities of the State to honour the bond. It is concluded that the most effective approach is to inject a type of bond which is more in line with the sort of asset which a bank would voluntarily hold on its balance sheet: short-term, and with interest rate floating in line with the market. Such an instrument can more easily be made marketable, thereby freeing the bank to move forward with an asset-side strategy that is not dependent on its particular failure history.

The cost of servicing a marketable bond of c. €120bn would be c.€2.1bn per annum. It is calculated - on the basis of €100bn of investment property assets being transferred to the AMC - that even allowing for a high level of impairment of these assets, the cash flows generated would be sufficient to ensure no net burden in terms of additional service costs.

Business Model of the NAMA:
In relation to the various categories of assets taken on, NAMA will be charged with their management in terms of disposal, holding, consolidating and creation of joint ventures for maximising return on the assets. In order to discharge the functions, NAMA will need to establish or source functional competence in: Legal; Project Finance; Project management; Planning and Design (external); Sales & Marketing (external).

Review of the Guarantee Scheme:
It is recommended that the Guarantee of bank liabilities be restructured to:
- extend the Guarantee to cover future longer term bond issuance;
- remove dated subordinated debt (Lower Tier 2), asset covered securities, and senior unsecured debt maturing beyond the 29 Sep 2010, from coverage of the guarantee, because the covered institutions get no benefit from the guarantee of these types of liabilities;
- change some of the commercial conduct provisions to enhance supervisory powers;
- make technical amendments to clarify certain issues raised by the market.

Appendix 2 – Strategic Options

This appendix assesses the high level options available to the Government to address the current threat to the stability of the Irish banking system.

Take no further action

Banks are currently managing the loans as impaired or distressed assets. Banks are not currently enforcing on these loans due to concerns as to the level of losses, the value of underlying collateral and the impact on their capital of any write downs. If they could continue to fund themselves, the banks could continue to adopt this approach until such time as the market improves at which stage the borrowers may be able to repay the loans or the banks might be in a position to enforce the loans and sell the relevant properties.

Pros	Cons
• Less immediate Exchequer exposure. • Forces banking system to address its own issues.	• Ultimately will threaten the financial position of the banks • Delays market adjustment and prolongs serious economic distortions • Will not assist lending to real economy • Potential to cause serious damage to the real economy • Will not address liquidity risk • Will not be acceptable to the market • Heightens risk of sovereign default

Establish an insurance scheme

The State could establish an insurance scheme whereby, for example, it provides insurance to each of the Banks against the majority of the losses they incur on the relevant loans above a certain "first loss" position (for example, 20 per cent.). The loans would remain on the books of the Bank who would continue to manage them over time. It is also likely that the banks would be required to share a proportion of the losses above that first loss amount (perhaps another 10 per cent. of all amounts covered by the insurance) to incentivise them to achieve the best recovery for the loans. The banks will pay a fee to the State for providing the insurance (in cash or securities of the bank) and any insurance payments could be settled by means of the State delivering government bonds to the banks which they could use as collateral to obtain cash in the market or from the ECB.

Pros	Cons
• No initial cash outlay and no immediate impact on GGD • Banks continue to fund themselves • Banks remain responsible for managing the loans • Some precedent, similar to the UK scheme • State could earn a fee (subject to complicated State Aid issues and banks ability to pay)	• Loans remain on Bank's books. No finality, and no clean break • Banks continue to manage loans in their own interests, not in the interests of the State • The insurance is a large contingency, and its unknown what the final cost will be. Uncertainty will weigh on the State's finances • No "floor" on property values and limited control for the State • Large degree of complexity considering competing objectives • Significant issues in pricing the insurance and allocating the losses • Significant time to establish

Asset Management Agency

An Asset Management Agency ("AMA"), often termed a "bad-bank", would be established, probably as a non-deposit-taking, unregulated statutory body. It would purchase from certain eligible banks the non-performing loans, issuing government bonds as the purchase price.

There would be cap on the amount available to the AMA to purchase the loans. Eligibility criteria for banks able to make use of the AMA would have to be drawn up, e.g. based on systemic importance, access to similar schemes in other countries, etc. Banks would be subject to a time-limit within which they would have to make use of the AMA.

The AMA would then operate under a mandate provided to it in legislation to manage the loans or, in appropriate circumstances, enforce the loans, crystallise the defaults and hold the property on behalf of the State over time. When appropriate it would sell the properties back into the property market.

Pros	Cons
• Significantly cleanses the good banks, is a "clean break" • State has complete control over process • Allows good banks increase lending to the real economy • The company would have market power enabling it to prevent fire sales • Precedent: This is very similar to the successful Swedish model and the US RTC model used to deal with the S&L crisis • No ongoing regulation or need to maintain minimum capital, as not a bank • Complimentary to recapitalisation of AIB and Bank of Ireland • No legacy issues in institution, as brand new • Helps to put some "floor" on asset values • Upside (if any) belongs to the State • State owning the land may have other benefits, building schools hospitals etc • Is the most transparent option • Offers better potential for stimulating bank liquidity raising	• Significant impact on GGD and State credit rating • Initial high cost, as asset purchases are funded on day-one (although no need for cash, as government securities can be provided) • Transfer of loans will crystallise losses with corresponding capital impact • Establishment of a new structure to run the portfolio • Identification of appropriate experts, not connected with existing problem assets and banks to run AMC • Market acceptance of increased level of Irish government bond issuance is required • Political implications and conflicts of interests in managing the portfolio • Eligibility for scheme may potentially be broader than for bank guarantee scheme, i.e. could have to extend to non-covered institutions • Will need some continuing access to cash to assist in loan workouts • May not generate sufficient investor interest to meet the resultant additional debt and other costs.

Appendix 3

The tables below highlight the impact of the financial transaction proposed in the Bacon report on the balance sheets of the banks (6 covered institutions), the AMC and the Government. (All figures in billions)

Aggregated Bank Balance Sheet- Before			
Assets		Liabilities	
L&D Loans	€64	Deposits	€240
Property Inv Loans	€95	CP & CDs	€40
Other Loans(mortgages etc)	€281	Interbank	€43
Treasury Assets	€75	Long Term Funding	€125
Other Assets	€45	ECB	€52
		Subordinated Debt	€20
		Equity	€40
TOTAL	€560		€560

Aggregated Bank Balance Sheet - After			
Assets		Liabilities	
~~L&D Loans~~	~~€64~~	Deposits	€240
~~Property Inv Loans~~	~~€95~~	CP & CDs	€40
Other Loans	€281	Interbank	€43
Treasury Assets	€75	Long Term Funding	€125
Other Assets	€45	ECB	€52
Gov Bond	€120	Subordinated Debt	€20
		~~Equity~~	~~€40~~
TOTAL	€520		€520

Asset Management Company Balance Sheet			
Assets		Liabilities	
Bank Loans	€120	Gov Debt	€120

Government Balance Sheet			
Assets		Liabilities	
Loan to AMC	€120	Increased Gov Debt	€120

Appendix 4
Proposed Asset Management Bridge Scheme [formerly "CLS"]

It is expected that current extreme liquidity pressures on the Irish banking system will persist and may even intensify following any announcement of an Asset Protection Scheme for the banking sector (i.e. Asset Management Company and / or risk insurance).

The Central Bank and Financial Services Authority of Ireland (CBFSAI) currently has ECB approval for an Emergency Liquidity Assistance (ELA) facility of €15bn. for Anglo Irish Bank.

While it is legally feasible for an institution to decide not to disclose that it is drawing ELA, the longer the institution remains on ELA the stronger the legal onus may be to disclose it particularly when the institution's shares are traded. In addition the information published in the CBFSAI's monthly balance sheet will identify (but not in an obvious way) that substantial ELA is being provided in the Irish market which is likely to lead to the information coming out in the market in any event or unhelpful speculation as to who is accessing ELA.

Very careful consideration therefore needs to be given to whether any other large systemic publicly traded institution in Ireland should be permitted to access ELA. It is considered that the 'bad name' that any institution which is known to be drawing ELA will acquire will accelerate the pace of liquidity outflows and make it very difficult for that institution ever to be in a position to fund itself in the market again.

Consequently, it is proposed that as a short term alternative an asset swap arrangement is put in place for the covered institutions by the NTMA which if necessary will allow them to acquire ECB liquidity in respect of their non-ECB eligible collateral. This will be achieved by swapping this collateral (a substantial proportion of which is high quality) for Irish Government short dated Treasury Bills specifically issued for this purpose (under powers available under section 6(11) of the Credit Institutions Financial Support Act, 2008 (CIFS)). The bonds can then be repo-ed with the ECB.

This approach mirrors mechanisms that have been put in place in some other EU Member States. In order for the system to work, the ECB must be prepared to accept these Treasury Bills. The CBFSAI has consulted with the ECB and it has been indicated that the bills will be accepted. The current assessment is that this funding model could yield up €[60] bn. to the banking system in Ireland. At current rates of outflow this amount amounts to approximately [10] weeks liquidity. It, therefore, provides very valuable additional time for efforts to stabilise the Irish banking system to work. It also allows ELA to be provided only to certain institutions, thereby distinguishing the systemically viable ones. It would, if fully implemented, however, result in approximately a doubling in ECB liquidity provided to the Irish banking system from €60bn. to €120bn. – at which time Ireland would account for in excess of [15%] of total ECB liquidity. It should be noted that this level of ECB exposure to Ireland would be expected to generate very significant political pressures. It is also important to note that this Scheme could result in an increase in the Government's borrowing to € [135bn].

It is proposed in order to seek to accentuate the impact on market perceptions of an announcement of the establishment of an Asset Management Agency in Ireland to encourage positive liquidity inflows, that this asset swap arrangement would be termed the Asset Management Bridge Scheme to stress the extent that it is complementary and temporary for the purpose of underpinning the establishment of the Asset Management Agency.

Appendix 5: Guarantee Scheme Review

A review of the Guarantee is currently underway, as required by the European Commission and the terms of the Guarantee Scheme itself, with the purpose of establishing whether the Guarantee continues to assist in achieving the objectives of the Act of 2008 and whether there remains a continued justification for the provision of financial support under the Guarantee Scheme.

In summary, whilst the Guarantee had a successful short-term impact, the following long-term deficiencies have been identified which require the Guarantee to be restructured if its existence is to remain both effective and justified:

- There are market concerns regarding the credibility of the Guarantee given the scale of the guaranteed liabilities of €440bn.
- The Guarantee focuses solely on liquidity and does not address the issue of deteriorating asset quality and the consequent potential for significant write-downs and capital reductions as debts arise in the covered institutions.
- The liquidity position of the Irish banking system remains under extreme stress with the Guarantee not proving effective in preventing these outflows.
- Key to the covered institutions' long term sustainability is their ability to maintain deposits and their ability to obtain long-term funding from the markets. In practice, the majority of the liabilities covered by the guarantee are short/medium term bonds which were already in issue when the Guarantee was introduced – in this regard the Guarantee does not assist the covered institutions to obtain new long-term funding.
- Credit institutions in other EU Member States, e.g. the UK and France, have been able to make use of guarantees relating to long-term funding. In contrast, the covered institutions have not been able to raise longer term funding with a maturity post-29 September 2010. In fact, they have not had very much success raising even short-term funding (less than €7bn) that matures within the period of the Guarantee. As a result, the covered institutions remain very heavily reliant on ECB funding.
- By virtue of being the first guarantee of its kind and the urgency of its introduction, the Guarantee is generally out-of-step with the guarantee models used in other EU Member States.

There no intention to withdraw the Guarantee at this stage. Indeed, such a move could have an extremely negative impact on both the State (in terms of reputation and creditworthiness) and the covered institutions. Instead, it is proposed that the Guarantee Scheme be restructured as follows:

- An extension of the Guarantee Scheme to cover longer-term bond issuance by the covered institutions. This would be in line with both international and EU trends where the average term of State cover for bond issues extends beyond 2010.
- Changes to some of the commercial conduct provisions contained in paragraphs 36 to 49 of the Guarantee Scheme, in order to enhance the Minister of Finance, Central Bank and Financial Regulator's supervisory powers in relation to the covered institutions for the duration of the Guarantee.
- Purely technical amendments to the Guarantee Scheme to clarify certain matters which have given rise to queries from the market and interested parties.

A case could also be made that in order to enhance its credibility the scope for reducing the contingent liability under the Guarantee should be examined. In this context, it is argued that the covered institutions do not derive any benefit from the Guarantee from the inclusion of:-

(a) dated subordinated debt (Lower Tier 2);

(b) asset covered securities; and

(c) senior unsecured debt that matures or extends beyond the expiry of the Guarantee on 29 September 201

The migration of some or all of these liabilities from the Guarantee would lead to a very substantial reduction in the State's contingent liability under the Guarantee. The significant strengthening of the risk position of the covered institutions that would result from their participation in an asset protection scheme may, therefore, provide an opportunity for consideration of the removal of certain liabilities from the Guarantee. It is of course essential that any plans in this area are subject to comprehensive exploration so as to ensure that the market response will be positive and that there will be no negative impact on the State's creditworthiness.

Any restructuring of the Guarantee will require both legislative and State aid approval. An extension of the 'blanket' guarantee currently in place to encompass longer-term bond issuance may be difficult to secure from the European Commission on account of the further divergence it would represent from the common EU framework for bank guarantees currently in place.

Appendix 6: State aid aspects to the Bacon report

Background
The European Commission published a Communication on the Treatment of Impaired Assets in the Community Banking Sector on 27 February, 2009. The Communication provides guidance on how the Commission will review asset-relief measures under the Community rules on State aid. The following issues arise in the context of the Bacon Report, and the proposal to transfer all property related assets of the six covered institutions to an AMC, in light of the Communication.

Eligible Assets
First, in relation to the type of assets that might be covered by an asset-relief measure, such as an asset insurance scheme or, as proposed in the Bacon Report, an asset purchase scheme, the Commission states in its Communication that assets that cannot presently be considered impaired should not be covered by an asset-relief programme (para. 35). The Commission also states that asset relief should not provide an open-ended insurance against future consequences of recession (para. 35) and that it would not consider assets eligible for asset relief measures where they have entered the balance sheet of the beneficiary bank after a specified cut-off date prior to the announcement of the relief measure, say, end 2008 (para. 36).

The Bacon proposal would include, as part of an asset purchase programme, assets such as Building and Development Land loans which clearly constitute impaired assets but also commercial loans which may not constitute impaired assets. Consequently, the State would have to justify the inclusion of such assets in any scheme. It would be necessary to show that the extent of the scheme is necessary and justified in the circumstances if the proposal is to work. The Commission suggests in its Communication that it may be possible for banks to be released of impaired assets if the assets represent a maximum of 10-20% of the overall assets of the bank covered by the relief measure but again this appears subject to the premise that the assets involved are impaired.

Cost to the State
A second issue that arises in the context of the Bacon proposal is the cost involved to the State. In this regard, the Commission refers in its Communication to the impact which any proposal might have on the budgetary position of Member States. The Bacon proposal would add €124bn. to the national debt at end 2009-a total of €199bn (111% of GDP). Against that, and the upfront cost in general, it may be that some of the assets involved would prove profitable in the future which would reduce the overall cost involved to the State. This has been the case in some of the "Bad Bank" schemes in the past, for example, in Sweden.

Eligible institutions
Third, as with previous proposals discussed with the Commission, the Commission is likely to raise an issue with respect to the fact that the scheme would only apply to the six covered institutions. This point has been made by Commission officials in initial discussions. The State would argue that the extent of the problem is focussed on these six banks and, therefore, that should also be the focus of the proposal. It might also be pointed out that some other banks may receive similar support through their parent in other Member States.

Valuation process etc.
In addition to these considerations the Commission will want to ensure that the process it outlines in its Communication on the review of asset-relief measures is followed. This would relate to matters such as the valuation of the assets, enrolment in the scheme, reviews of the scheme, likely restructuring plans for the banks involved, appropriate remuneration for the State and behavioural commitments on the part of the banks.

2.20 The elements of the consideration paid for the loans together with explanations of each are set out in Figure 2.2.

Figure 2.2 Consideration for loans

	AIB	Anglo	BOI	EBS	INBS	Total
	€m	€m	€m	€m	€m	€m
Loan balance	20,381	34,261	9,867	903	8,739	74,151
Derivatives	74	145	44	-	-	263
Borrower debt	**20,455**	**34,406**	**9,911**	**903**	**8,739**	**74,414**
Market value of property (30 November 2009)	**9,261**	**13,310**	**5,681**	**399**	**3,766**	**32,417**
Long-term value of underlying property						
Land (including development property < 30% complete)	2,955	2,543	1,516	96	1,413	8,523
Residential property for resale	1,802	1,824	960	173	476	5,235
Investment property	4,051	8,202	2,788	151	1,072	16,264
Hotels	565	1,512	502	1	887	3,467
Development property (>30% complete)	564	397	423	6	217	1,607
Total	**9,937**	**14,478**	**6,189**	**427**	**4,065**	**35,096**
NAMA valuation						
Collateral associated with loans						
Present value of property cash flows	9,606	14,443	6,055	413	3,800	34,317
Cash security	94	319	61	4	10	488
Other security	577	619	137	8	27	1,368
Total collateral	10,277	15,381	6,253	425	3,837	36,173
Excess collateral	(978)	(1,189)	(483)	(19)	(205)	(2,874)
Legal discount	(86)	(283)	(2)	(1)	(122)	(494)
Collateral available to the State	**9,213**	**13,909**	**5,768**	**405**	**3,510**	**32,805**
Due diligence and enforcement adjustment	(360)	(510)	(206)	(16)	(158)	(1,250)
Net loan collateral	8,853	13,399	5,562	389	3,352	31,555
Qualifying advances	148	153	50	-	42	393
Initial consideration	9,001	13,552	5,612	389	3,394	31,948
Post-acquisition adjustment	(30)	(144)	(23)	-	27	(170)
Final consideration	**8,971**	**13,408**	**5,589**	**389**	**3,421**	**31,778**
Discount	56%	61%	44%	57%	61%	57%
Loan current market value [a]	7,403	11,162	4,590	317	2,679	26,150
State aid	**21%**	**20%**	**22%**	**23%**	**28%**	**22%**

Source: National Asset Management Agency and analysis by the Office of the Comptroller and Auditor General.

Note: a The current market value of the loans was calculated using a model developed by NAMA's financial advisors.

Figure 2.2 continued: Explanation of Elements

Loan balance	The amounts owed by borrowers at loan valuation date and including qualifying advances made after 7 April 2009.[1]
Derivatives	The market value at acquisition time of the performing financial derivatives for which NAMA gave consideration.
Borrower debt	This is the total of the loan balances and the value of the associated performing derivatives owed by the borrowers.
Market value of property	The market value of property at 30 November 2009 pledged as collateral by borrowers.
Long-term value of underlying property	The long-term value of land, residential and investment property, hotels and development property is the market value plus the uplift applied by NAMA to derive the property's long-term value. These are the proceeds that it is anticipated the properties would realise if disposed of when the market crisis conditions have normalised.
Present value of property cash flows	The present values of the real estate collateral cash flows associated with the loans that comprise the assumed disposal proceeds and any projected rental income discounted to present values using the NAMA discount rates.
Cash security	Cash held as collateral by the participating banks.
Other security	The collateral, other than property or cash, held as security by the participating banks.
Excess collateral	In some instances, the value of the collateral provided by borrowers exceeded amounts owed. Adjustments were made so that the consideration given did not exceed the loan balances and associated derivatives. In some cases, the legal structure of a borrower's loans prevented cross collateralisation to other loans.
Legal discount	The amount that has been deducted by NAMA arising from legal issues relating to the possible enforceability of NAMA's security and title rights over loan collateral.
Collateral available to the State	The net value of the collateral pledged by borrowers — the present value of property cash flows and the current market value of other securities less excess collateral and any legal discounts applied by NAMA.
Due diligence and enforcement[2]	A discount of 5.25% was applied to the long-term value of the properties to provide for due diligence (0.25%) and enforcement costs (5%) incurred or likely to be incurred by NAMA. This is the present value, after application of the discounts, of the amount by which the consideration paid to the participating banks was reduced for this provision.
Net loan collateral	The value of the collateral following deduction of the provision for due diligence and enforcement costs.
Qualifying advances	Advances made by a participating institution to borrowers after 7 April 2009 (the date on which the Minister for Finance announced the Government's intention to establish NAMA). Under direction from the Central Bank and the Financial Regulator, following direction from the Minister, no discount was applied to such advances if they were deemed to be part of normal commercial banking arrangements.
Initial consideration	The initial amount paid by NAMA for the acquired loans and associated financial derivatives, prior to adjustments made under the Act.
Post-acquisition adjustments	The Act allows for the adjustment of the acquisition value of a loan subsequent to its acquisition where there has been an error in the acquisition process or value attributed to the loan.
Final consideration	The final amount paid by NAMA for the acquired loans and associated financial derivatives, post adjustments made under the Act.
Discount	The percentage difference between the consideration paid and borrower debt at loan valuation date.
Loan current market value	The present value of the property cash flows, using the current market value of the property, discounted at market rates for distressed loans.
State aid	The difference between the final consideration and the loan current market value expressed as a percentage of the loan current market value.

1 NAMA paid the lower of the value of the collateral cash flows and the amount owed by the borrower, including derivatives, at a date specified by NAMA for each tranche and for each participating bank. For example, for the first tranche, the loan valuation date for all participating banks was 31 January 2010.

2 In implementing this provision, NAMA applied the 5.25% discount to the long-term value of property pledged as collateral for loans. There were some loans where the difference between the loan balance and the post-discount value of the collateral was less than the actual amount of the discount applied to the collateral. In these cases, not all of the discount was deducted from the consideration paid.

Key statistics for the construction industry

	2006	2007	2008	2009	2010E
GNP (constant 2008 prices, €m.)	153,398	160,299	154,672	138,161	136,089
% volume change in GNP	+6.5	+4.5	-3.5	-10.7	-1.5
Gross domestic fixed capital formation (GDFCF) (Constant 2008 prices, €m.)	45,193	46,456	39,806	27,482	21,106
Volume Change in GDFCF (%)	+4.6	+2.8	-14.3	-31.0	-23.2
Total construction output					
Value output (current prices €m.)	38,631	38,601	32,593	18,048	11,733
Change in value of construction output (%)	+14	+0	-16	-45	-35
Value output (constant 2008 prices €m.)	34,838	35,057	32,593	20,646	14,540
Change in volume of construction output (%)	+10	+1	-7	-37	-30
Construction output as % of GNP *	25.1	23.7	21.1	13.8	9.2
New construction output **					
Public sector new construction output ***					
Value of output (constant 2008 prices, €m.)	6,375	7,008	8,564	8,025	7,045
Change in volume of construction output (%)	+0	+10	+22	-6	-12
As % of total construction output *	17	19.6	26	40	50
Private sector new construction output **					
Value of output (constant 2008 prices, €m.)	21,324	20,356	16,040	6,379	2,270
Change in volume of construction output (%)	+13	-5	-21	-60	-64
As % of total construction output *	64	60	49	28	13

	2006	2007	2008	2009	2010E
Direct employment in construction (000s Q4)	268	264	216	137	110
Direct plus indirect employment (000s Q4, est.)	376	369	303	191	154
Change in capital goods price index for building and construction (materials and wages) (%)	+6	+5	+3	-2	+1
Change in building and construction price index for all materials (%)	+8	+5	+3	-3	+3
Change in tender prices (est) (%)					
- New housing	+4	-2	-12	-22	-12
- New general contracting	+4	-1	-11	-17	-10
- New civil engineering	+4	+4	-6	-7	-7
Change in total construction price inflation	+4	-1	-9	-13	-8

Notes:
* Percentages derived using output measured in current prices.
** The balance, not shown in the table, is repair and maintenance output (32% of total output in 2009 and 37% in 2010).
*** The estimate for new public sector construction includes an estimate for private sector investment under education, energy and telecommunications (estimated at €0.9bn in 2009 and €0.6bn in 2010).

3.1 Construction employment

The construction sector has been the sector most severely hit by the economic recession. This reflects the repercussions of the property debacle over the past four years but also the over reliance on construction. In terms of which ever indicator is selected, it is acknowledged that the construction sector had reached unsustainable heights at the time, accounting for 25% of the overall economic activity (GNP), 27% of private sector lending (excluding residential mortgages)[49], 13% of the employed workforce and providing new dwellings at a rate of 20 per one thousand of the population, when the corresponding figure for the rest of Europe was an average of 5 units.

The phenomenal acceleration in construction output in the five years to 2007 resulted in employment in the industry reaching unsustainable levels, with one in every 5 persons working in the economy either directly or indirectly employed in construction. Aligned with the growth in output came higher standards and new methods of construction, a more rigorous regulatory environment and new areas of activity, which led to a demand for new skills and new occupations. As a result the industry built up a substantial skills base and considerable expertise which left it well placed to deliver the range of high quality building and infrastructure needs of a successful and expanding economy.

145,300 direct jobs lost in construction since the peak – 57% of total job losses

However, the ending of the property boom and the changes in the economy's fortunes, which commenced in 2008, rapidly led to a reversal in the growth in construction employment witnessed throughout the preceding decade. The number of persons directly employed in construction had peaked in Q2 2007 at 272,600. The severity of the contraction in construction output which ensued thereafter led to the loss of 145,300 direct jobs in the sector by Q2 2010. This total represented 57% of all job losses in the economy over the period. The next worst affected economic sector over the same period was the Industrial sector, which accounted for 23% (or 59,400) of total job losses. The Retail and Wholesale sector followed with 29,500 job losses, just 11.5% of the total.

Full impact on construction reveals over 200,000 job losses– almost 80% of the total

Employment has inevitably taken a hit across each of the three main sectors of activity: residential, general contracting and civil engineering. However, the full scale of the impact of the recession on construction employment can be ascertained by taking into account the job losses which materialised with respect to those persons both directly and indirectly employed in each sector. The latter captures the impact on employment right across the construction supply chain, including the jobs lost in firms that provide inputs to construction projects plus the jobs lost in those firms that supply the firms providing the inputs and so on.

[49] According to the Central Bank Quarterly Report (Q3 2008) the level of outstanding loans to the property and construction sector stood at €112 billion at end of June 2008, or 27% of total private sector loans outstanding at the time. This figure excludes residential mortgages which stood at €145 billion, 35% of the total at the time.

Distribution of largest debtors

Distribution of largest debtors

Table 2 provides a breakdown of all debtor connections by size of nominal debt exposure. It should be noted that many of the debtors are also indebted to financial institutions which are not part of the NAMA scheme.

Nominal Debt	Number of debtor connections	Average nominal debt per connection €m	Total nominal debt in this category €m
In excess of €2000m	3	2,758	8,275
Between €1000m and €2000m	9	1,549	13,945
Between €500m and €999m	17	674	11,454
Between €250m and €499m	34	347	11,796
Between €100m and €249m	82	152	12,496
Between €50m and €99m	99	68	6,752
Between €20m and €49m	226	32	7,180
Less than €20m	302	7	2,117
Total	772	96	74,015

Table 2: Distribution of NAMA debtor connections by size of nominal debt

PwC Impairment Scenarios for entire loan book

Applying the following basis point provisions against the loan books at 30 September 2008 indicates the possible future loan losses on the whole loan books shown below for Scenarios 1 and 2. This does not take into account impairment provisions that will or have been included in financial statements for years ending in calendar year 2008 or 31 March 2009.

Scenario Analysis

Loan Category	Impairment bps Scen 1	Impairment bps Scen 2
Residential Mortgages	15	15
RIPS	120	120
Commercial / Corporate	150	125
Development land without planning permission	1,000	1,500
Development land with planning permission	600	1,000
Consumer lending unsecured (incl credit cards)	300	300
Consumer lending secured	150	100

Scenario 1 - Impairment Charges

€ millions	FY09	FY10	FY11	Total
Allied Irish Banks plc	3,203	3,203	3,203	9,609
Bank of Ireland	2,359	2,359	2,359	7,077
Anglo Irish Bank	2,255	2,255	2,255	6,765
Irish Life & Permanent	316	316	316	948
Educational Building Society	105	105	105	315
Irish Nationwide BS	387	352	221	960

Scenario 2 - Impairment Charges

€ millions	FY09	FY10	FY11	Total
Allied Irish Banks plc	4,052	4,052	4,052	12,156
Bank of Ireland	2,799	2,799	2,799	8,397
Anglo Irish Bank	2,980	2,980	2,980	8,940
Irish Life & Permanent	320	320	320	960
Educational Building Society	125	125	125	375
Irish Nationwide BS	496	445	316	1,257

Source: Letter from PricewaterhouseCoopers (PwC) January 2009

These scenarios are for illustrative purposes only and do not take account of a number of factors including, but not limited to:

- Security including cross guarantees held by the institutions;
- A material event occurring that may result in a significant spike in any one year;
- A number of major developers going into insolvency at the same time resulting in surplus residential stock or other property coming onto the market at the same time;
- The length of time before a recovery starts in the economy;
- Remedial actions taken by the Covered Banks; and
- Accruing operating profits before impairments.

(*c*) protecting or otherwise enhancing the value of those assets, in the interests of the State.

(2) So far as possible, NAMA shall, expeditiously and consistently with the achievement of the purposes specified in *subsection (1)*, obtain the best achievable financial return for the State having regard to—

(*a*) the cost to the Exchequer of acquiring bank assets and dealing with acquired bank assets,

(*b*) NAMA's cost of capital and other costs, and

(*c*) any other factor which NAMA considers relevant to the achievement of its purposes.

Functions of NAMA.

11.—(1) In order to achieve its purposes, NAMA shall perform the following functions:

(*a*) acquire, in accordance with *Part 6*, such eligible bank assets from participating institutions as it considers necessary or desirable for achieving its purposes;

(*b*) hold, manage and realise acquired bank assets (including the collection of interest, principal and capital due, the taking or taking over of collateral where necessary and the provision of funds where appropriate);

(*c*) perform such other functions, related to the management or realisation of acquired bank assets, as the Minister directs pursuant to *section 14*;

(*d*) take all steps necessary or expedient to protect, enhance or realise the value of acquired bank assets, including—

(i) the disposal of loans or portfolios of loans in the market for the best achievable price,

(ii) the securitisation or refinancing of portfolios of loans, and

(iii) holding, refinancing, realising and disposing of any relevant security.

(2) In the exercise of its functions NAMA shall have regard to the need to avoid undue concentrations or distortions in the market for development land.

(3) The Minister may confer on NAMA, by order, such additional functions connected with the functions for the time being of NAMA as he or she thinks necessary for the achievement of its purposes, subject to such conditions (if any) as may be specified in the order.

(4) An order under this section may contain such incidental, supplemental and consequential provisions as are, in the opinion of the Minister, necessary to give full effect to the order.

(5) An order under *subsection (3)* shall be laid before each House of the Oireachtas as soon as may be after it is made and, if a resolution annulling the order is passed by either such House within the next 21 days on which that House has sat after the order is laid

(3) The content of a report provided to the Minister under this section may be taken to be confidential information.

(4) A reference in *subsection (1)* to the performance of the functions of NAMA includes the performance of those functions by a NAMA group entity.

Audit of accounts by Comptroller and Auditor General.

57.—(1) NAMA and each NAMA group entity shall submit its accounts to the Comptroller and Auditor General for audit within 2 months after the end of the financial year to which they relate, and the Comptroller and Auditor General shall—

(*a*) if he or she is satisfied that the accounts represent a true and fair view of the state of the affairs of NAMA or the NAMA group entity concerned, so certify, or

(*b*) otherwise qualify the accounts.

(2) NAMA shall present a copy of the accounts of NAMA and each NAMA group entity as audited to the Minister as soon as may be and the Minister shall cause a copy of the audited accounts to be laid before each House of the Oireachtas.

Accountability to Committee of Public Accounts.

58.—(1) The Chairperson, and the Chief Executive Officer, shall, whenever required by the Committee of Dáil Éireann established under the Standing Orders of Dáil Éireann to examine and report to Dáil Éireann on the accounts and reports of the Comptroller and Auditor General, give evidence to that Committee on—

(*a*) the regularity and propriety of the transactions recorded or required to be recorded in any book or other record or account subject to audit by the Comptroller and Auditor General that NAMA or a NAMA group entity is required by or under an enactment to prepare,

(*b*) the economy and efficiency of NAMA and each NAMA group entity in its use of the resources made available to it under this Act,

(*c*) the systems, procedures and practices employed by NAMA and each NAMA group entity for evaluating the effectiveness of its operations, and

(*d*) any matter affecting NAMA or any NAMA group entity referred to in—

(i) any special report of the Comptroller and Auditor General under section 11(2) of the Comptroller and Auditor General (Amendment) Act 1993, or

(ii) any other report of the Comptroller and Auditor General (in so far as it relates to a matter specified in any of *paragraphs (a)* to *(c)*) that is laid before Dáil Éireann.

(2) In appearing before a Committee referred to in *subsection (1)*, the Chief Executive Officer appears as an accountable person and not as an accounting officer.

Applications for designation as participating institution.

62.—(1) A credit institution may apply to the Minister, within 60 days (or such longer period that the Minister prescribes by order under this subsection) after the establishment day, for it and its subsidiaries to be designated as participating institutions. A credit institution that applies under this subsection shall include all of its subsidiaries in the application (including those that it has requested be excluded from designation).

(2) An applicant credit institution may include in its application a request to exclude particular subsidiaries from designation, and shall give reasons for any requested exclusion.

(3) An application under *subsection (1)* shall be in the form that the Minister directs. The Minister may direct that different forms shall be used for that purpose by different credit institutions.

(4) The Minister may direct an applicant credit institution to provide, as part of its application, a certificate, supported by a statutory declaration, in relation to it and all of its subsidiaries collectively, jointly by the chief executive officer and chief financial officer of the applicant credit institution—

(*a*) that since 30 July 2009, it and each of its subsidiaries has dealt in the way required by *section 66(1)* with such of its bank assets as the Minister specifies, or if to any extent it has not done so, the extent to which it has not done so, and

(*b*) that the information in the application is accurate and complete.

(5) An applicant credit institution that is a subsidiary shall furnish an undertaking by its parent company to provide any information and do anything else required of the parent company or any other member of its group to enable the Minister to consider the application. The Minister is not obliged to consider an application by a subsidiary if no such undertaking is given.

(6) An applicant credit institution shall undertake to obtain all necessary consents, in accordance with any applicable law including the consents of all its subsidiaries (including subsidiaries that it has requested be excluded from designation) and any necessary consent of any other member of its group. The Minister may consider the relevant application whether or not he or she has evidence that any relevant consent has been obtained and is not required to seek evidence of any such consent.

(7) An applicant credit institution may make an application under this section notwithstanding that at the time of the application it has not yet received any or all of the necessary consents.

Effect of application for designation, etc.

63.—(1) By making an application under this Chapter the applicant credit institution and all of its subsidiaries shall be taken to undertake, subject to any prohibition in any applicable law, to comply with the provisions of this Act (including this Act as amended from time to time) and of any regulations made under it (including any regulations made designating further classes of bank assets as eligible bank assets), so far as those provisions apply to it as an applicant or participating credit institution. As and from the making of the application they shall be bound to comply with that undertaking.

67.—(1) The Minister, after consultation with the Governor and the Regulatory Authority, may designate an applicant credit institution as a participating institution if the credit institution has applied under *section 62* to be so designated.

Designation of participating institutions.

(2) The Minister shall not designate an applicant credit institution as a participating institution unless he or she is satisfied that—

(*a*) the applicant credit institution is systemically important to the financial system in the State,

(*b*) the acquisition of bank assets from the applicant credit institution or its subsidiaries is necessary to achieve the purposes of this Act, having regard to—

(i) support that—

(I) is available to,

(II) has been received by, or

(III) in normal commercial circumstances might reasonably be expected, or might reasonably have been expected, to be or to have been available to,

the applicant credit institution or its subsidiaries from the State, any other Member State or a member of the group of the applicant credit institution,

(ii) the financial situation and stability of the applicant credit institution and its subsidiaries,

(iii) the financial situation and stability of the applicant credit institution's group in the event that bank assets are not acquired from the applicant credit institution or its subsidiaries, and

(iv) the resources available to NAMA and the Minister,

and

(*c*) the applicant credit institution has complied with all of its applicable obligations under this Act.

(3) The designation of an applicant credit institution as a participating institution operates to designate as participating institutions all of its subsidiaries except any subsidiary excluded under *subsection (6)*.

(4) Designation (including designation of a subsidiary in accordance with *subsection (3)*) has effect notwithstanding the absence of any necessary consent to the relevant application. Designation of a subsidiary does not prejudice any rights that the subsidiary may have against the relevant applicant credit institution.

(5) Before deciding whether to designate an applicant credit institution as a participating institution, the Minister, having consulted the Regulatory Authority, may direct that specified due diligence and stress testing of the applicant credit institution or any member of its group be carried out.

Chapter 2

Designation of Eligible Bank Assets

Eligible bank assets.

69.—(1) The Minister may, after consultation with NAMA, the Governor and the Regulatory Authority, and considering the purposes of NAMA and the resources available to the Minister, prescribe, by regulation, classes of bank asset as classes of eligible bank asset.

(2) The classes of bank assets prescribed under *subsection (1)* may include—

(*a*) credit facilities issued, created or otherwise provided by a participating institution—

(i) for the purpose, whether direct or indirect and whether in whole or in part, of purchasing, exploiting or developing development land,

(ii) where the security connected with the credit facility is or includes development land,

(iii) where the security connected with the credit facility is or includes an interest in a company engaged in purchasing, exploiting or developing development land,

(iv) where the credit facility is directly or indirectly guaranteed by a company referred to in *subparagraph (iii)*,

(v) directly or indirectly to a debtor who has provided security referred to in *subparagraph (ii)* or *(iii)*, or

(vi) directly or indirectly to a person who is an associated debtor of a debtor to whom a credit facility described in any of *subparagraphs (i)* to *(iii)* has been provided,

(*b*) credit facilities and classes of credit facilities (other than credit facilities referred to in *paragraph (a)*) relating to debtors or associated debtors of participating institutions (or classes of debtors or associated debtors of participating institutions) where the total amount of indebtedness in respect of such facilities is such that, in the opinion of the Minister, acquisition by NAMA is necessary for the purposes of this Act,

(*c*) other rights arising directly or indirectly in connection with a credit facility described in *paragraph (a)* or *(b)* including—

(i) a contract to which the participating institution is a party or in which it has an interest,

(ii) a benefit to which the participating institution is entitled, and

(iii) any other asset in which the participating institution has an interest, (*d*) bank assets associated with bank assets specified in *paragraphs (a)* and *(b)*, and

(*e*) any other class of bank asset of a participating institution the acquisition of which the Minister is of opinion, after consultation with the Commission of the European Communities, is necessary for the purposes of this Act.

(3) In forming an opinion for the purpose of *subsection (2)(b)*, the Minister may take into account—

(*a*) the total number of credit facilities or classes of credit facilities provided by the participating institution to those debtors and associated debtors or classes of debtors and associated debtors, and

(*b*) the aggregate indebtedness of debtors and associated debtors or classes of debtors or associated debtors referred to in *subsection (2)(b)* owed to any other participating institution.

(4) A bank asset that is in a class prescribed under *subsection (1)* is referred to in this Act as an "eligible bank asset".

(5) A class of bank asset prescribed under *subsection (1)* shall be taken not to include a credit facility that entered a participating institution's balance sheet after 31 December 2008. For the avoidance of doubt, where a credit facility entered a participating institution's balance sheet on or before 31 December 2008, but security was taken for the credit facility after that date, and the credit facility is otherwise an eligible bank asset, the credit facility is an eligible bank asset.

(6) Notwithstanding *subsection (5)*, a bank asset in a prescribed class is an eligible bank asset if, in the opinion of NAMA, the related credit facility entered a participating institution's balance sheet on or before that date even if renegotiated or refinanced after that date. For the purposes of determining whether a credit facility entered a participating institution's balance sheet on or before 31 December 2008, NAMA may take into account the terms of any renegotiation, restructuring or refinancing of a credit facility effected after 31 December 2008.

Meaning of "associated debtor" in this Act.

70.—(1) For the purposes of this Act, a person is an "associated debtor" of a debtor if the person—

(*a*) is or was at any time directly or indirectly indebted or otherwise obligated to a participating institution under or in connection with a credit facility, and

(*b*) is or was at any time—

(i) a body corporate that was a subsidiary of, or a related company (within the meaning given by section 140(5) of the Companies Act 1990) to, the debtor,

(ii) a nominee of the debtor, including a person who may or does in fact act at the express or implied direction or instruction of the debtor or another associated debtor of the debtor, (*b*) so act in relation to those bank assets in good faith having regard to the purposes of this Act.

(2) A participating institution shall not without the prior written approval of NAMA—

(*a*) deal with any of its eligible bank assets otherwise than in the ordinary course of its business,

(*b*) deal with any of its eligible bank assets in such a way as to prejudice or impair NAMA's prospective interests or priorities in relation to such a bank asset,

(*c*) compromise any claim or release, vary, relinquish or otherwise take or omit to take any action if its doing so could reduce, lessen or impair any security, right, obligation, ranking or priority held or enjoyed, directly or indirectly, in connection with such a bank asset, or

(*d*) amend or vary any contract relating to such a bank asset unless contractually obliged to do so.

(3) NAMA may issue guidelines or policy statements in relation to the kinds of transactions that it is likely to be prepared to approve under *subsection (2)*.

PART 5

Valuation Methodology

Interpretation (*Part 5*).

72.—(1) In this Part "property" means property that is the subject of the security for a credit facility that is a bank asset.

(2) In this Part:

(*a*) a reference to the market value of property is a reference to the estimated amount that would be paid by a willing buyer to a willing seller in an arm's-length transaction after proper marketing (where appropriate) where both parties act knowledgeably, prudently and without compulsion,

(*b*) a reference to the market value of a bank asset is a reference to the estimated amount that would be paid by a willing buyer to a willing seller in an arm's-length transaction after proper marketing (where appropriate) where both parties act knowledgeably, prudently and without compulsion,

(*c*) a reference to the long-term economic value of property is a reference to the value, as determined by NAMA in accordance with this Part, that it can reasonably be expected to attain in a stable financial system when the crisis conditions prevailing at the passing of this Act are ameliorated and in which a future price or yield of the property is consistent with reasonable expectations having regard to the long-term historical average, and

(*d*) a reference to the long-term economic value of a bank asset is a reference to the value, as determined by NAMA in accordance with this Part, that it can reasonably be expected to attain in a stable financial system when the crisis conditions prevailing at the passing of this Act are ameliorated.

Determination of acquisition values — valuation dates, etc.

73.—(1) NAMA may specify a date or event by reference to which the market value of a bank asset or type of bank asset or property or type of property is to be determined.

(2) Under *subsection (1)* NAMA may specify different dates or events for any or any type of bank assets or property.

(3) Under *subsection (1)* NAMA may specify a date before the coming into operation of this Act.

(4) The specification of a date or event under *subsection (1)* has effect for the determination of a market value for any purpose under this Act (including for the purposes of *Chapter 2* of *Part 7*).

Determination of acquisition values — guidelines, etc.

74.—NAMA may, for the purpose of determination of values in accordance with this Part, adopt such guidelines or rules as it considers necessary for efficiency or consistency.

Acquisition values.

75.—(1) Subject to *subsection (2)* and any regulations made by the Minister under *subsection (3)*, the acquisition value of a bank asset is its long-term economic value as determined by NAMA.

(2) NAMA may, if it considers it appropriate after consultation with the Minister, and subject to any regulations made by the Minister under *subsection (3)*, having regard to—

(*a*) the purposes of this Act,

(*b*) the expected date of acquisition of the bank asset concerned,

(*c*) the type of bank asset,

(*d*) the laws of the European Communities governing State aid, and

(*e*) any other relevant matter affecting valuation,

determine that the acquisition value of a bank asset shall be—

(i) its market value, or

(ii) a value (between its long-term economic value and its market value) that NAMA considers appropriate in the circumstances, having regard to the matters specified in *paragraphs (a)* to *(e)*.

(3) The Minister may make regulations for the purposes of the application of *subsection (2)*. For that purpose the Minister shall have regard to the factors set out in *paragraphs (a)* and *(c)* to *(e)* of *subsection (2)*.

Determination of long-term economic values.

76.—(1) NAMA shall determine the long-term economic value of a bank asset having regard to the following:

(*a*) the market value of the property;

(*b*) the market value of the bank asset;

(*c*) the long-term economic value of the property;

(*d*) the long-term economic value already determined by NAMA, in accordance with the valuation methodology, of any other similar property or bank asset;

(*e*) any report prescribed under *section 78* that is reasonably available to NAMA when it carries out the valuation of the particular property or bank asset,

in accordance with—

(i) any regulations made by the Minister under *section 79*, and

(ii) the laws of the European Communities governing State aid.

(2) Notwithstanding any other provision of this Act or any regulations made under it—

(*a*) the long-term economic value determined by NAMA for a parcel of land shall not exceed the market value of the parcel by more than such fraction as the Minister may determine by regulations for the purposes of this paragraph,

(*b*) the total long-term economic value of all land held as security in an acquired portfolio shall not exceed the total market value of that land by such fraction as the Minister may determine by regulations for the purposes of this paragraph,

(*c*) NAMA may determine that, with regard to any particular class of property, or in the particular circumstances applicable to a parcel of land, its long-term economic value shall not exceed its market value, and

(*d*) the long-term economic value of a bank asset shall be calculated on the basis of net present value methodology.

Market values.

77.—(1) In determining the market value of property, NAMA may take into account—

(*a*) any value that the participating institution concerned submits as being, in its opinion, the market value of the property,

(*b*) any report prescribed under *section 78* that is reasonably available to NAMA when it carries out the relevant valuation, and

(*c*) the market value already determined by NAMA of another similar property.

(2) In determining the market value of a bank asset NAMA may take into account—

(*a*) any value that the participating institution concerned submits as being, in its opinion, the market value of the bank asset,

(*b*) the market value already determined by NAMA of any other similar bank asset,

(*c*) the creditworthiness of the debtor or obligor concerned,

(*d*) the performance of that asset, and

(*e*) the market value of property determined by NAMA under *subsection (1)*.

78.—The Minister may make regulations prescribing reports or classes of reports (including reports prepared before the commencement of this Act) concerning factors or matters relevant to the valuation of property or of property of a particular type or in specific locations or with specific features or benefits, including— Regulations in relation to certain reports.

(*a*) zoning,

(*b*) availability of utilities,

(*c*) availability of similar property in similar locations,

(*d*) historic value of property in particular locations, and

(*e*) recent valuations of similar property in similar locations.

79.—(1) The Minister may make regulations relating to the determination by NAMA of the long-term economic value, or the market value, of a bank asset or a class of bank asset or a property or a class of property, including the matters that NAMA shall or may derive, use, apply or take into account for those purposes. Regulations in relation to determination of values.

(2) In making regulations for the purposes of *subsection (1)*, the Minister shall have regard to the laws of the European Communities governing State aid and any relevant guidance issued by the Commission of the European Communities, and may have regard, and may include such provisions relating, to such of the following as he or she thinks appropriate:

(*a*) with reference to the long-term economic value of property—

(i) the extent to which the price or yield of such property has deviated from the long-term historical average,

(ii) supply and demand projections by reference to the type of asset and its location,

(iii) macroeconomic projections for growth in the gross domestic product and for inflation or deflation,

(iv) demographic projections,

(v) land and planning considerations (including national, regional or local authority development or spatial plans) that may exert an influence on the future value of the asset concerned,

(vi) analyses presented by the Minister for the Environment, Heritage and Local Government on the extent to which existing land zoning and planning permissions granted and in force meet or exceed projected growth requirements,

(vii) analyses presented by the Dublin Transportation Office or any national transport authority of existing and future transport planning and the associated supply and demand projections for land use,

(viii) any analysis by the Minister for Communications, Energy and Natural Resources in relation to the potential rise in energy and other costs due to the long-term decline in non-renewable resources,

(ix) the specification, for the purposes of the determination of the long-term economic value of particular parcels of land, of a fraction by which the long-term economic value determined by NAMA shall not exceed the market value of each such parcel,

(x) the specification, for the purposes of the determination of the long-term economic value of all land held as security in acquired portfolios, of a fraction, by which the long-term economic value of that land shall not exceed its total market value;

(*b*) with reference to the long-term economic value of bank assets—

(i) the long-term economic value of property,

(ii) the net present value of the anticipated income stream associated with bank assets of that kind,

(iii) in the case of rental property, current and projected vacancy rates,

(iv) loan margins,

(v) an appropriate discount rate to reflect NAMA's cost of funds plus a margin that represents an adequate remuneration to the State that takes account of the risk in relation to the bank assets acquired by NAMA,

(vi) the mark-to-market value of any derivative contracts associated with bank assets of that kind,

(vii) any ancillary security such as personal guarantees and corporate assets, and

(viii) fees reflecting the costs of loan operation, maintenance and enforcement;

(*c*) such other matters that he or she considers relevant to the long-term economic value or market value of property or bank assets including—

(i) matters to be derived, used, applied, taken into account or not taken into account;

(ii) the values to be attributed to any matters or the adjustments to be made in or by virtue of their application;

(iii) the data, criteria, information, rules and methodology that may be used or applied in determining the value or application of any matters or in deriving any matters to be used or applied;

(iv) the use of the net present value methodology in determining the value of any property or bank asset;

(v) the appropriate discount rate to reflect NAMA's cost of funds plus a margin that represents an adequate remuneration to the State that takes account of the risk in relation to the acquired bank assets to be applied in determining the net present value of a cash flow;

(vi) the specification, for the purposes of attribution and application across all bank assets, or all bank assets of a particular class, of a standard discount rate, to be attributed to or applied in the calculation of each bank asset, or each bank asset of the particular class, as the case may be, acquired by NAMA, which in the opinion of the Minister is necessary or appropriate to provide for enforcement costs, due diligence costs and other relevant costs incurred or likely to be incurred by NAMA over its lifetime in the discharge of its functions;

(vii) the extension of the maturity date of any bank asset for such period as NAMA considers appropriate after its actual maturity to allow a reasonable period for its management and enforcement;

(viii) the types or classes of property in respect of which the market value shall be deemed to be the long-term economic value.

(3) Every regulation made under *subsection (1)* shall be laid before each House of the Oireachtas as soon as may be after it is made and, if a resolution annulling the regulation is passed by either such House within the next 21 days on which that House has sat after the regulation is laid before it, the regulation shall be annulled accordingly, but without prejudice to the validity of anything previously done under the regulation.

(*b*) the acquisition value determined by NAMA for each such bank asset, and

(*c*) the total value for those assets.

(3) NAMA shall not serve any further acquisition schedules on a participating institution after service of a completion notice on the institution unless the Minister prescribes further classes of eligible bank assets.

Dispute over acquisition value.

98.—(1) If a participating institution wishes to dispute an acquisition value, it shall do so solely in accordance with this section and *sections 121* and *122*.

(2) A participating institution may apply to NAMA in writing for the correction of an obvious error in relation to the value of a bank asset in an acquisition schedule. An application under this subsection is not an objection or dispute for the purposes of *sections 121* and *122*.

Chapter 2

Effects of Acquisition of Bank Assets

NAMA to have rights of creditors after acquisition of bank assets.

99.—(1) After NAMA or a NAMA group entity acquires a bank asset, and subject to *section 101* and any exclusion of obligations and liabilities from the acquisition set out in the acquisition schedule—

(*a*) NAMA and the NAMA group entity each have and may exercise all the rights and powers, and subject to this Act is bound by all of the obligations, of the participating institution from which the bank asset was acquired in relation to—

(i) the bank asset,

(ii) the debtor concerned and any guarantor, surety or other person concerned,

(iii) any receiver, liquidator, or examiner concerned, and

(iv) the Official Assignee in Bankruptcy,

and

(*b*) the participating institution ceases to have those rights and obligations except to any extent to which this Act provides otherwise.

(2) The reference in *subsection (1)* to the rights, powers or obligations of a participating institution in relation to a bank asset is a reference to the rights, powers or obligations, as the case may be—

(*a*) derived from the bank asset, and

(*b*) arising under any law or in equity or by way of contract.

(3) In particular, NAMA and the NAMA group entity may each—