TUARASCÁIL ón gComhchoiste Fiosrúcháin i dtaobh na Géarchéime Baincéireachta

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

REPORT of the Joint Committee of Inquiry into the Banking Crisis

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

Volume 1: Report
Volume 2: Inquiry Framework
Volume 3: Evidence

Dept. of Finance
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January 2016

Table of contents – by line of inquiry

R1: Effectiveness of the Regulatory, Supervisory and Governmental Regime Structure

R1b: Effectiveness and appropriateness of the supervision policy and powers

Description	Bates Number [Relevant Pages]	Page
Irish Government White Paper Regulating Better 2004.pdf (Extract)	INQ00069 [001,003,006-009]	2-7
Statement Con Horan about 'Better Regulation (Extract)	CHO00013 [002]	8
Context Phase Hearing Governor Honohan page 123 Directors Compliance Statements (Extract)	PUB00273 [025-026]	9-10
Financial Regulator Annual Report 2006 - Ref to Better Regulation (Extract)	PUB00030 [014]	11
Honohan Report - IFSC/promotion of Financial Services Industry (Extract)	PUB00075 [001,016,034-037,052,056-059,090,094,104, 115,116,119-142,146-149]	12-55
DoF Summary on Nyberg Report Recommendations (Extract)	DOF02474 [001-011]	56-66
Review 'note to Minister re Directors' compliance statement	DOF06807 [001-007]	67-73
Statement Patrick Neary on 'Regulating Better' (Extract)	PNE00001 [007-009]	74-76
Statement Tom Considine about 'Better Regulation' (Extract)	TCO00002 [001-002]	77-78

R1c: Appropriateness of the macro economic and prudential policy

Description	Bates Number [Relevant Pages]	Page
FTI Consultancy's Data Repository for Inquiry [Extract] Fig.16: Cyclical Taxes as % of Total Tax Revenue (1992-2013) Fig. 10 and 11: Credit Growth, 2004 to 2013 Fig. 27 and 28: Credit for Construction Projects, 1992 to 2010 (Extract)	INQ00050 [001,007,009,012-019]	80-90
Hearing John Hurley, Page 6 on property incentives, page 51 on meetings with Minister (Extract)	INQ00047 [006,051]	91-92
Narratives based on INQ 00002	INQ00067 [001-018]	93-110
NTMA Letter by J Corrigan to Minister on budgetary impact and solutions on promissory notes 08 Sep 2011	NTMA00269 [001-003]	111-113
Hearing Tom O'Connell on pre budget advice, pages 95-97 (Extract)	INQ00068 [022-024]	114-116
Wright Report - Strengthening the capacity of the Dept of Finance (Extract)	PUB00175 [001,004-008,021-027,032-033,041, 044-047,065-078]	117-150

Based on the average of national new and second-hand house price, CSO statistics	PUB00399 [001]	151

R1d: Composition, skills, experience and number of resources at the Central Bank, Regulator and Department of Finance

Description	Bates Number [Relevant Pages]	Page
Staffing Issues	DOF02157 [001]	153
Staffing Issues	DOF02197 [001]	154
Staffing Issues (Extract)	DOF02401 [001]	155
MAC Meeting on 31 May 2004 – Decentralisation (Extract)	DOF02420 [001-002]	156-157
Staffing Issues (Extract)	DOF02448 [002]	158
Recruitment and retention paper to MAC 26/04/01	DOF07409 [001-010]	159-168
Staffing issues (Extract)	DOF07432 [001]	169
Staffing issues – skill levels	DOF07433 [001]	170
Staffing issues – skill levels	DOF07434 [001]	171

THEME: R1

Effectiveness of the regulatory, supervisory and governmental regime structure

LINE OF INQUIRY: R1b

Effectiveness and appropriateness of the supervision policy and powers

Roinn an Taoisigh
Department of the Taoiseach

Regulating Better

A Government White Paper setting out six principles of Better Regulation

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Consistency

Necessity

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Department of the Taoiseach

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Taoiseach's Foreword

Enhanced competitiveness is a key part of the Government's strategy to achieve social progress, better living standards and a steadily improving quality of life. I am absolutely committed to ensuring that Ireland continues to be a competitive and open economy and that we do not erode the social and economic progress we have made as a country over recent years. This White Paper deals with good quality regulation, which has an essential role in achieving these objectives. It sets out core principles that the Government will adhere to in regulating and outlines a number of steps that will be taken to put the principles into practice.

Our exceptional economic growth in recent years has enabled Ireland to make significant gains on a number of fronts. Employment expanded, the unemployment rate fell rapidly, much-needed infrastructural projects were put in place or initiated, and living standards rose significantly. However, in the current, more uncertain global economic environment we need new avenues through which we can maintain and enhance our competitiveness. We also need to ensure that the benefits of greater competitiveness and of heightened domestic competition are transferred to citizens and businesses. Better Regulation is one of the instruments available to achieve this.

Historically, much Government attention has been focused on the traditional instruments of Government, such as current expenditure, taxation and investment. Little importance has been given to regulatory policy. However, increasingly in OECD countries, greater attention is being paid to choosing the most appropriate regulatory framework. The coming years are likely to be crucial, domestically and internationally, in establishing the right mix of regulatory policies, tools and institutions. This White Paper establishes core principles to guide these choices and, in doing so, provides for greater participation and transparency in policy-making and contributes to a better environment for the individual, the community and for business.

While many countries now recognise that Better Regulation is vitally important for competitiveness and economic growth, Better Regulation also has a role to play in promoting inclusiveness and good government for all citizens. Thus, the core principles set out in this White Paper also relate to the quality of governance and the efficiency and effectiveness of the public service.

It is widely accepted that, as well as providing predictability and certainty in the business world, good quality regulation contributes to establishing and maintaining individual freedom and social cohesion, not least through articulation and protection of citizens' and consumers' rights. However, the reverse is also true. Bad or cumbersome regulation not only creates barriers to efficient markets, thereby discouraging competition and innovation, but also alienates citizens from government and can contribute to unfair income and wealth distribution.

Reflecting the importance of regulation in many areas of economic and social policy, the latest social partnership agreement, *"Sustaining Progress"*, contains commitments to publish a White Paper on Regulation and introduce Regulatory Impact Analysis (RIA). At EU level, the Better Regulation agenda has been gaining momentum in recent years, particularly in terms of the stated need, in the Lisbon objectives, to pursue a simpler regulatory environment. The European Commission is implementing an action plan on simplifying and improving the regulatory environment which Ireland is actively supporting.

This White Paper sets out core principles of good regulation. It also goes further: it sets out a programme of actions to give effect to these principles. I look forward to seeing these actions being implemented and to a new drive for economic competitiveness, social progress and better Government.

Bertie Ahern

BERTIE AHERN, T.D.
Taoiseach

Executive Summary

Introduction

The Government has prepared *"Regulating Better"*, a Government White Paper that will contribute to improving national competitiveness and better Government by ensuring that new regulations – Acts and Statutory Instruments (Orders) – are more rigorously assessed in terms of their impacts, more accessible to all and better understood. Existing regulations will be streamlined and revised, where possible, through a process of systematic review and by repealing, restating and consolidating them as appropriate. This White Paper will also contribute to better regulatory processes and institutions, including a more consistent approach to the establishment and design of independent sectoral regulatory authorities.

Principles

This White Paper identifies what the Government sees as the principles of good regulation:

NECESSITY – is the regulation necessary? Can we reduce red tape in this area? Are the rules and structures that govern this area still valid?

EFFECTIVENESS – is the regulation properly targeted? Is it going to be properly complied with and enforced?

PROPORTIONALITY – are we satisfied that the advantages outweigh the disadvantages of the regulation? Is there a smarter way of achieving the same goal?

TRANSPARENCY – have we consulted with stakeholders prior to regulating? Is the regulation in this area clear and accessible to all? Is there good back-up explanatory material?

ACCOUNTABILITY – is it clear under the regulation precisely who is responsible to whom and for what? Is there an effective appeals process?

CONSISTENCY – will the regulation give rise to anomalies and inconsistencies given the other regulations that are already in place in this area? Are we applying best practice developed in one area when regulating other areas?

Approach taken

The approach of this White Paper is both practical, in that it is action-oriented, and pragmatic in that the Government is not "for or against" regulation. Rather, the Government favours Better Regulation. Regulation is an integral part of the process of governing and it will continue to be so. Legislation and subsidiary regulations have a critical role to play in key areas of economic and social life. The recommendations and actions in this White Paper are best seen in the context of the continuing drive for competitiveness and people's expectations of high quality public services. Many of the principles and commitments reflect good practice and developments regarding regulation internationally. For example, many of our European Union (EU) partners and the EU institutions themselves are developing similar principles and actions.

Overview of Actions

The Government will make better use of evidence-based policy-making. This means making better use of research and analysis in both policy-making and policy implementation. Regulation is an expression of policy and **Regulatory Impact Analysis (RIA)** is an evidence-based approach that allows for the systematic consideration of the benefits and costs of a regulatory proposal to the economy and society. The Government will pilot a system of RIA in a small number of Departments and, following the pilot phase, RIA will be integrated with existing procedures. RIA will give special consideration to business impacts, especially in respect of Small and Medium Enterprises (SMEs). RIA will be integrated with developments under the e-Cabinet project and will be supported through training, guidelines and promotion.

Systematic reviews of the regulation of key areas and sectors will be carried out which will involve reviewing the regulatory institutions in place, as well as the body of regulation governing particular areas.

To improve the internal consistency of regulation in particular areas, the Government will implement a programme of **Statute Law Revision**, including a major project to update pre-1922 legislation. The Government will also use RIA to ensure the effectiveness of new regulations, taking account of the existing body of regulation.

Emphasis will be placed on developing proposals for improvements to the procedures for **appealing regulatory decisions**. For example, consideration will be given to establishing expert panels of judges to deal with specific competition and sectoral regulation cases.

In considering the burden of complying with regulations, the Government will review:

i) compliance and the question of linking penalties and fines to income and ability to pay; and

ii) the extent to which the criminal justice system is capable of efficiently dealing with the complexities of modern regulatory issues.

The Government will also monitor the cumulative burden of **compliance** on business and SMEs to ensure that compliance costs are fair and proportionate with the benefit the regulation brings.

The Government will ensure that new regulations are better understood, by publishing **explanatory guides** alongside primary legislation with significant impacts, in particular those that impact directly on consumers/citizens/SMEs. Similar steps will be taken to improve the quality of the explanatory material that accompanies secondary law/statutory instruments containing major proposals.

The Government will also encourage the establishment of norms and standards for **consultation** processes and will keep under consideration the need for legislation underpinning administrative procedures.

The Government will create new **sectoral regulators** only if the case for a new regulator can be clearly demonstrated in light of existing structures. It will assess the possibilities for rationalisation of sectoral regulators along with promoting the strengthening of existing contacts between the sectoral regulators, the Competition Authority and the Office of the Director of Consumer Affairs.

To further improve customer service delivery, the Government will require Departments to streamline service delivery and **administrative processes** where possible, using the latest technology, along with the introduction of customer charters, to reduce the burden of compliance on the citizen.

The Government intends to strengthen the capacity for evidence-based policy-making by ensuring that **Departments** promote training and awareness-raising of policy analysis skills. Departments will also be required to report, through their Strategy Statements and Annual Reports, on regulatory reforms and service improvements.

A key to Better Regulation will be clarity and accessibility of regulations. The Government will improve the coherence of legislation through **revision, restatement and repeal**, by ensuring greater consistency in the drafting of Statutory Instruments and maximising the use of IT/e-Government initiatives to improve clarity and accessibility of regulations.

Next steps

A detailed Action Programme is set out in this White Paper, along with assignments of responsibility and indicative timescales. A **Better Regulation Group** will be established and it will be asked, inter alia, to report back regularly to the Government on implementation of these actions by Departments, Offices and Agencies.

A principles-based approach to supervision imposed general standards and principles on regulated institutions and essentially placed the onus of responsibility for compliance with such principles, and other requirements imposed, on the boards and senior management of the institutions.

The supervisory authority (the regulator) operated a fitness and probity regime to ensure that those in control of the organisation had a proper background and operated control systems that were consistent with the strategy of the bank.

The approach was consistent with that adopted by supervisory authorities in most of the main financial centres, including the United Kingdom.

Internationally, it was considered to be the most appropriate manner of supervision to address the growing complexity of banking, advances in risk management and for facilitating innovation in the industry; the latter being a factor which was considered to have increased the overall resilience of the financial system. Such innovation was identified as a key component in bringing about what had become known as the 'Great Moderation'. This phrase was coined by economists to describe the long-period of pre-crisis macro-economic calm, with stable growth, stable inflation and stable banks (Appendix: Section 1).

Speeches and corporate publications of IFSRA made regular references to the desire to foster innovation and competitiveness and, for the system to work properly, the need to trust those at the helm of financial institutions to act prudently. Given the international trends, a principles-based approach to supervision was also seen as important in developing Ireland as an international centre for financial services. Further, in accordance with the 'Better Regulation' agenda, the financial services industry in Ireland had been given significant influence over the approach to supervision in Ireland. The Financial Services Consultative Industry Panel ('FSICP'), which considered itself the 'lender of last resort' in a regulatory context for the financial services industry in its dealings with the regulator, was a strong supporter of the approach.[3]

Crucially, principles-based supervision was also promoted as best practice by the International Monetary Fund (IMF). In a paper entitled '*IMF Performance in the Run-Up to the Financial and Economic Crisis: IMF Surveillance in 2004–07,* the IMF identified that, pre-crisis, it had recommended to advanced countries to follow the 'light touch' U.S./U.K. approaches to the financial sector as a means to help them foster greater financial innovation.

Therefore, it is not surprising that another review of the crisis by the IMF *("The Making Of Good Supervision: Learning to Say "No")*, found that, internationally, there were "abundant" examples of supervision: (1) staying on the side lines and not intruding sufficiently into the affairs of regulated institutions; (2) being too deferential to bank management; (3) not being proactive in dealing with emerging risks and; (4) not being comprehensive in their scope.

However, no particular system of supervision fared well in the run-up to the crisis. The Spanish approach, which was initially lauded for its rules-based approach and intrusiveness (which involved the placing of large numbers of bank inspectors permanently on-site in the major banks), suffered similar problems to Ireland.

[3] Consultative Industry Panel Annual Report 2005

we tried to work out how the economy would have moved. That is one thing, and it gives an overall number.

However, also, and very often neglected in this, there are distributional effects and that is what we have been focusing on a lot - the paying for the banking crisis. There are capital gains and losses as well as the different economic effect. The economy would have been weaker during the early 2000s. Wages would have been lower, there would have been fewer jobs, there would have been less immigration, there would have been fewer houses and so forth. In the post-crisis situation, we would have been in a higher position. So there is balancing gains from losses and then there are the distributional effects - the winners and losers. The winners were people who sold property at a good time. The losers were the people who bought property at a wrong time, the Government, the shareholders and the poor subordinated debt holders of the banks who would actually have got their money back in full instead of with a big haircut. So, it is a big story and very interesting.

Deputy John Paul Phelan: Professor Honohan will not or does not wish to put a figure on it. I can understand why he does not wish to as it is a big question for sure. However, if, and he kind of touched on it in his answer, the banks had been prudently regulated in the period that he inquired into, would the figure that he has not given have been significantly lower?

Professor Patrick Honohan: Yes, but there would have been losses in the early period. Those 2000s would not have been as good for many of the people for whom they were good years. Not everybody. I am not saying everybody in the country -----

Deputy John Paul Phelan: Would the final net cost-----

Professor Patrick Honohan: Yes. Very substantial and much more than the €40 billion.

Deputy John Paul Phelan: I wish to refer specifically to pages 48 to 51 of Professor Honohan's report, where he makes reference to directors' compliance statements and the role of auditors. Subsequent to the publication of the report - I think in June or July 2010 - Professor Honohan was before the finance committee and he highlighted a number of areas that would merit further investigation. One of these was the role of auditors. In his report, he details that the then Minister for Finance, in December 2006, made it known to the Financial Regulator that before introducing a regime which would force bankers and auditors to sign a statement confirming their compliance with proper banking practices that it was important that they, and this is a direct quote, "assess the competitiveness issue". Can Professor Honohan elaborate on how significant he feels the Minister for Finance's intervention was at that particular time in preventing the degree of banker and auditor compliance being put in place by the regulator's office?

Professor Patrick Honohan: Our impression was that it was quite important and even today the Department of Finance officials or the Minister often will have communications. We meet regularly with officials and then will say, "What about this and this?" and they may make some good points and these will be taken into account. In this case, I think it might not have been the only reason but it was probably the end of the matter. I could imagine, although maybe I am just extrapolating rather than having concrete evidence, that that was the end of it. The Minister's letter would have been the end of it. That does not mean that there was something wrong with that *per se*. The Minister has a legitimate interest. There is no evidence provided that it is politically motivated or that some friend of the Minister thought something on it. It is a policy that the development of the financial sector is important and the Central Bank had to take account of the development of the financial sector. I do not think it was a good decision

and I think the Minister's intervention was an important one. We included that at some length to illustrate the fact that the regulator was not acting single-mindedly, in the prudential interest nor in full independence.

Deputy John Paul Phelan: As a follow-up question, what difference does Professor Honohan think it would have made if the Minister had not intervened?

Professor Patrick Honohan: Everything would have been fine. No. We have introduced these compliance statements now and so on, but it is kind of funny because the whole approach to regulation was relying on good governance of banks and this was a little piece of the jigsaw of that good governance and they were not prepared to put it in. It suggests a lack of coherence. I have to say that around that time there were similar measures - it is not the same story - such as the Sarbanes-Oxley measures requiring statements of this kind. It was a very controversial territory. It is not surprising that they shied away from it in the end.

Chairman: Can Governor Honohan acknowledge in his response that there was a change in the regulatory practice in the ten years prior to the guarantee and that we moved from one type of regulation to what is principles-based regulation? I think Deputy Phelan is in that space. However, Governor Honohan is answering the question, but he is not acknowledging that we moved from one regulatory framework to another type of regulatory framework.

Professor Patrick Honohan: First of all, I do not understand that there was much of a change in the prudential legal framework between the time before the establishment of the financial services authority and afterwards. There has been a change since then of course.

Deputy John Paul Phelan: I wish to refer to auditors. Professor Honohan was not specifically charged with investigating the role of auditors. He has flagged this a number of times and I mentioned a 2010 appearance before the finance committee when he flagged that the role of auditors needed to be examined a bit more. However, I am sure that, as part of this report, he would have had some sort of a cursory look at the role of internal and external auditors in the financial institutions at the particular time that he was looking at.

Professor Patrick Honohan: I think their work was not central, in a sense. There were not very many interactions - or we certainly did not explore any interactions - between the regulatory authorities and the auditors. The auditors helped the management of the banks to produce the accounts on which, to a large extent, the regulator was relying for statements - repeated statements - that the banks were well capitalised. What did they mean by well capitalised? Well, they looked at the audited accounts and the percentages of capital were very high compared to the requirements and so they said they were well capitalised. What did that mean? Had the auditors really dug into the asset quality review type of work and had they made enough provision for expected losses? There was a great debate around that time - from 2005 - as to whether the provisions against future losses could include an estimate of future expected losses in respect of items which had not been identified as troublesome. That was very controversial and all in all, the information coming from the audits probably deteriorated as a result of those changed international practices. The auditors will probably say when they appear before the committee that it is not their business to look at down side risks and possible problems around the corner of low probability. They will say that their business is "fair and complete"-----

Deputy John Paul Phelan: Do you think it is their business?

Professor Patrick Honohan: Certainly, at the very least, if people who use audited ac-

Effective Regulation, Fostering Innovation, Competitiveness and Competition in the Financial Services Industry

Mitigating Risk through Compliance

A principles-led approach to regulation is the right model for Ireland. It means that the responsibility for the proper management and control of a financial service provider, and the integrity of its systems, rests with its board of directors and its senior management. This approach focuses on outcomes, is robust and internationally credible. It both allows and requires financial service providers to manage themselves. This vital work is overseen by the Prudential Director. Financial service providers must have systems and policies in place to mitigate risk and monitor compliance with their internal policies. Our role involves oversight of the quality of the institution's corporate governance, including risk management and internal control systems.

We fully expect boards and senior management of all financial service providers operating in Ireland to adopt ethical behaviour and transparency in business dealings as key values. We do not examine each transaction or contract entered into by institutions to test compliance. Neither do we seek to interfere with the design of financial products. We expect all financial service providers, whether engaged in international or domestic activities, to comply with best practice. Where a financial service provider does not fulfil these reasonable expectations we have a number of enforcement measures available to us, culminating in administrative sanctions. I am satisfied that the majority of financial service providers operate to a high standard. This is borne out by the very small number of cases that required such actions in 2006.

Better Regulation

We strive for a regulatory system that is robust, is internationally credible and that allows financial service providers the freedom to run their businesses properly. We want to implement European regulation in a manner consistent with this approach. However, in keeping with this form of implementation, we must be able to depend on industry to honour the obligations and commitment that this model of supervision demands. We are committed to ensuring that our regulatory requirements do not become a barrier to competitiveness and innovation. We apply the Government's 'Better Regulation' principles and are active members of the Taoiseach's Better Regulation Group.

In accordance with the 'Better Regulation' principle of transparency, we consult publicly before introducing a new regulation. The Consultative Consumer and Industry Panels provide an important mechanism for ensuring that the consultation process with stakeholders is effective and efficient. Both Panels were invited to make a number of valuable submissions to us on a range of regulatory proposals, including our Strategic Plan for 2007-2009 and provided us with comments on our draft statement of income and expenditure. 2006 has been a year of further development in our constructive relationships with the two Consultative Panels.

Pictured at the Insurance Institute Industry Leaders Conference with the Chief Executive Patrick Neary who spoke at the event are (l–r) Michael Brennan, President, The Insurance Institute of Ireland; Mary Fulton, Partner, Deloitte; and Cormac McCarthy, Group Chief Executive Officer, Ulster Bank Group.

The Irish Banking Crisis
Regulatory and Financial Stability Policy
2003-2008

A Report to the Minister for Finance by the Governor of the Central Bank

31 May 2010

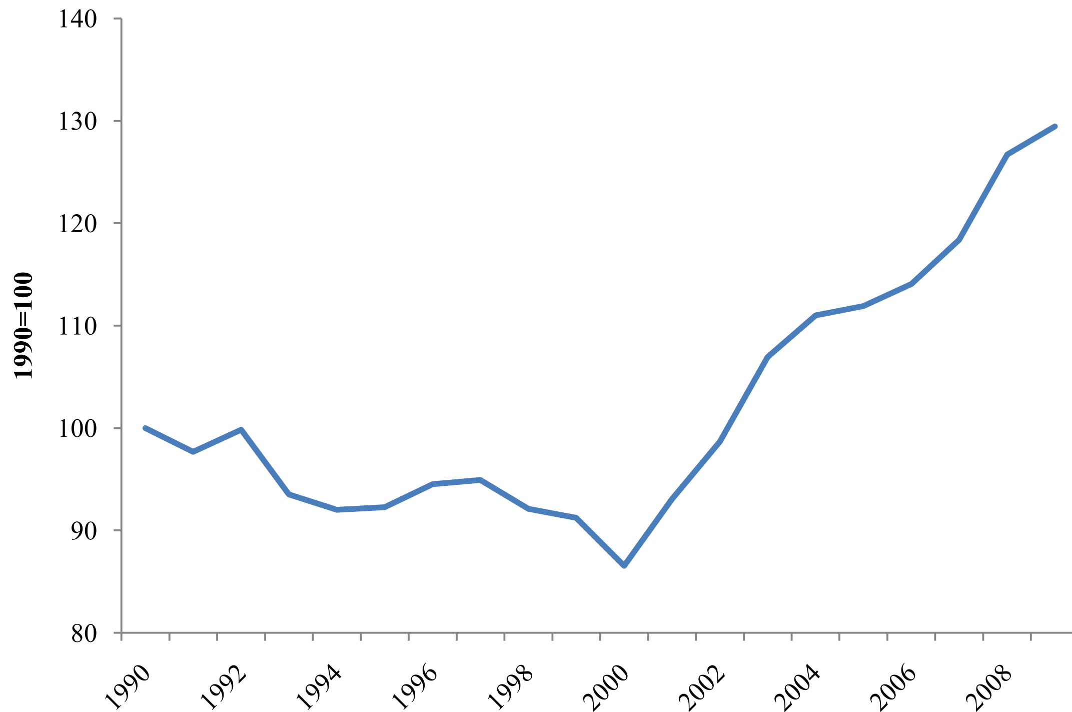
adhering to time-bound deadlines for escalation, the FR allowed some important matters to drift. At the same time the appetite for legal challenge was limited which meant that in practice entities were given the benefit of the doubt; no penalties for breach of prudential regulations were ever imposed on a bank before 2008. If unsuccessful, test legal cases could have helped garner support for additional legislative powers.

- Overall financial stability policy (Chapter 6)

1.15 The major tool of overall financial stability policy was envisaged to be the Financial Stability Report (FSR). The language of successive FSRs was too reassuring throughout, even as late as November 2007, and did little to induce the banks – or the public and policy makers – to adjust their behaviour to avoid the threats that lay ahead. The FSR drafting overemphasised the central forecast whereas it is the downside scenarios and the condition of the weakest institutions that are the most relevant for a financial stability assessment. Admittedly, the views of outside bodies such as the IMF and OECD – especially in later years – were not sharply different and must have provided reassurance to any internal doubters. In particular, the relatively glowing 2006 update of the IMF‘s specialised Financial Sector Assessment Program (FSAP) mission – an exercise designed precisely to identify any weaknesses in prudential regulation and financial stability policy – would have been enough to set any doubts that may have existed at rest. The FSAP Report‘s misinterpretation – for whatever reasons – of the prevailing Irish situation **must be considered unfortunate**.

1.16 Although the FSRs included significant analytical material analysing the **underpinnings of the property boom**, the relatively sanguine conclusions tended to be reached on a selective reading of the evidence. This was particularly true in the case of the 2007 FSR when, despite internal evidence available to the contrary, the central conclusion regarding a “soft landing” was not based on any quantitative calculations or analysis. This appears to have been a “triumph of hope over reality”. More generally, a rather defensive approach was adopted to external critics or contrarians. For years many observers had raised some concerns publicly or privately, albeit sometimes in coded form, about the sustainability of the property boom, which was indeed dramatic by international standards. For example, even though they appeared after most of the damage had already been done, the two 2007 articles by Morgan Kelly, while not backed up by in-depth quantitative research on the Irish situation, should nevertheless

Chart 2.7: Relative Hourly Earnings (Manufacturing) Ireland -v- Main Trading Partners, 1990-2010



Source: CBFSAI

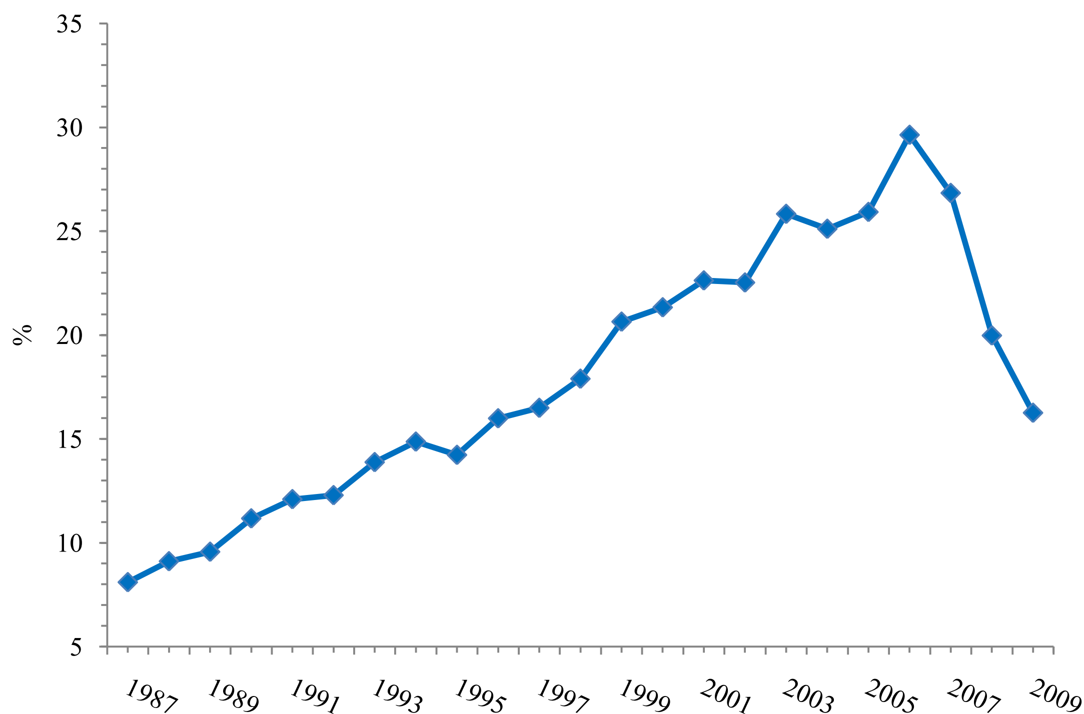
trading partner countries. Masked by the construction boom, this loss of wage competitiveness was certain to affect employment expansion sooner or later.[20]

2.23 Although Ireland's public debt level immediately prior to the crisis was low, the **fiscal deficit and public sector borrowing** surged quickly with the onset of the crisis. This was partly attributable to a rise in Government spending in GDP (after 2004) which became embedded in the system. The expenditure boost came at a period when elements such as the cost of unemployment payments was driving other cyclically-related spending down. However, in light of soaring tax revenues at the time, Government decided to increase autonomous spending particularly on public sector pay. But the main cause of the borrowing surge was the collapse in tax revenues in 2008-09 which appears to have been the most pronounced of virtually any country during the current downturn.

[20] Public sector workers, who had on average maintained a significant average wage premium relative to private sector workers during the Celtic Tiger period, seem to have stretched that premium in the years after 2003 (cf. Boyle et al., 2004; Kelly et al., 2008).

2.24 Much of the reason for the revenue collapse lies in the systematic shift over the previous two decades away from stable and reliable sources such as personal income tax, VAT and excises towards cyclically sensitive taxes. Revenue became increasingly dependent on corporation tax, stamp duties and capital gains tax (in that order); the contribution of these taxes to total tax revenues rose steadily from about 8 per cent in 1987 to 30 per cent in 2006 before falling to 27 per cent in 2007 and just 20 per cent in 2008 (Chart 2.8).

Chart 2.8: Cyclical Taxes as % of Total 1987 to 2009
(Corporation Tax, Capital Gains Tax and Stamp Duties)

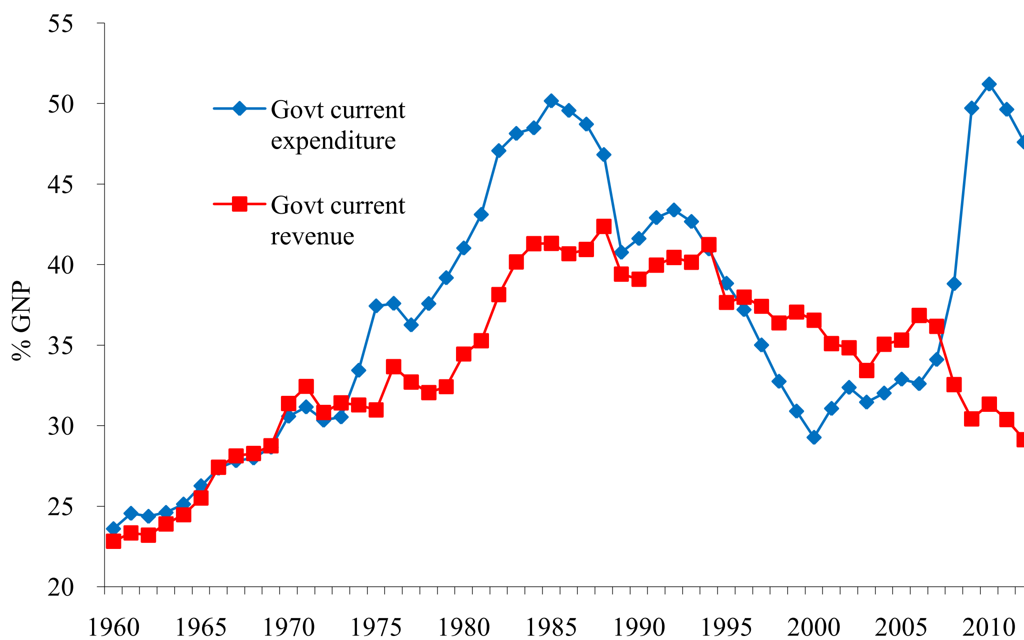


Source: Department of Finance, CBFSAI Calculations.

2.25 The steady growth in revenue from the above ―fair weather" taxes during the two decades from 1988 – with only two brief hesitations in 1993 and 2001-02 – created a false sense of security as to their sustainability and induced policy makers to take advantage by narrowing the base of the personal income tax and lowering rates. The latter did help buy wage restraint but left the budget seriously exposed to a downturn. Had the tax structure been less cyclically sensitive, the fall in revenue in 2008 would have been much lower.

2.26 Government spending doubled in real terms between 1995 and 2007, rising at an annual average rate of 6 per cent. With the economy growing at an even faster rate, this implied a generally falling or stable expenditure ratio of expenditure to GNP until 2003. But thereafter the ratio rose, especially after output growth began to slow in 2007. And, in a final twist, real expenditure rose by over 11 per cent in both 2007 and 2008, an unfortunate late burst of spending which boosted the underlying deficit at almost the worst possible time.

Chart 2.9: Current Government Expenditure and Revenue, 1960-2010



Source: Department of Finance, CBFSAI calculations.

2.27 Throughout this period, the Government made extensive use of taxation incentives aimed at the construction sector.[21] The rates of stamp duties, which were high, were lowered several times in recent years (in 2001, 2002, 2003, 2005, and 2007), sometimes with the aim of improving the affordability of housing to first time buyers (as was the case with the Bacon initiatives 1998-2000). In addition, different classes of construction investment have attracted sizeable income tax concessions extending over long periods. At the height of the boom, in 2004-06, schemes existed for urban renewal, multi-storey car parks, student accommodation, buildings used for third level

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[21] The effect of taxation on investment in construction is a complex subject [see studies by Barham (2004) Indecon (2006), Goodbody (2005), Van den Noord (2005) and Rae and van den Noord (2006)].

educational purposes, hotels and holiday camps, holiday cottages, rural and urban renewal, park and ride facilities, ―living over the shop", nursing homes, private hospitals and convalescent facilities, sports injury clinics and childcare facilities. After some transitional arrangements, most of these incentives were abolished by 31 July 2008, after the expiration date of the schemes had earlier been extended on several occasions during 2000-08.[22,23]

2.28 The ceiling on the income tax deductibility of mortgage interest for owner-occupiers was increased in 2000, 2003, 2007 and 2008. By 2006 Ireland was one of only four OECD countries which allowed income tax deductibility while not taxing imputed rental income or capital gains for owner-occupiers. Furthermore, no residential property tax existed. Still, the estimated tax bias in favour of owner-occupation was only the fifth highest in the EU15 countries (Rae and Van den Noord, 2006). For investors, after 2001 deductibility was limited only by the investor‘s rental income.

2.29 The above tax policy elements of the tax code certainly influenced the extent of construction activity and the level of land and property prices. In theory they might just have shifted the composition of Irish wealth in favour of construction and not necessarily have caused in themselves unsound borrowing or lending and defaults. However, studies of some of the schemes suggest that they became associated with over-building and high vacancy rates – phenomenon which are very evident today.

Section 6: Disentangling the Effect of Lehman Brothers

2.30 It would be a significant mistake to suppose that the steep economic downturn that has been experienced since 2007 is wholly due to the working out and correction of underlying domestic imbalances that have been described. After all, there has been a severe world-wide recession, the causes of which involve the correction of imbalances in the US, UK and elsewhere – excesses which have their own complexities not shared in the Irish case.

2.31 It is useful to consider more specifically what might have been the relative contribution of local factors to the Irish output loss. As a first approximation, Chart 2.10 compares

[22] Tax incentive schemes in the health sector were not abolished in 2008. However, these were later abolished in the Supplementary Budget 2009.

[23] For example, in the case of the Urban and Town Renewal Schemes, end-dates of 31 December 2002, 31 December 2004 and 31 July 2006, had previously been specified.

> providers having compliance systems, controls and internal audit departments that have the standing and the powers to meet the standards of behaviour that we now expect of those we regulate. We set out those standards; they must invest in the system and staff to ensure those standards are met."[40]

The Chair of the Authority also pointed out that for the ―principles based approach to work there must be mutual trust, between ourselves and industry and a shared aspiration to do our best together."[41]

4.9 The Financial Regulator eventually set out nine principles to reflect what the FR expected from the financial institutions (Box 4.1). They first appeared in the FR's Annual Report for 2006[42]. However, it appears that the nine principles were not the focus of any systematic checks, either desktop or on inspection; and, unlike the FR's principles for the protection of consumers, they were never incorporated into a unitary Code.[43] Hence breaches of the general principles for financial institutions were not subject to the Administrative Sanctions Procedure discussed below.

Box 4.1: The Authority's Principles for Financial Service Providers
1. Conduct their functions in a transparent and accountable manner. 2. Act with prudence and integrity and in the best interests of their customers at all times. 3. To maintain at all times sufficient financial resources to meet their commitments. 4. Have in place sound corporate governance structures. 5. Have oversight and reporting systems that allow board and management to monitor and control all operations. 6. Have in place internal controls that are adequate for the nature, scale and complexity of their operations. 7. Have risk management policies systems appropriate to the nature, scale and complexity of their operations. 8. Comply with any regulatory rules set down by the Financial Regulator in relation to, for example, solvency and capital adequacy, segregation of client funds, consumer protection codes. 9. When required, to produce accurate, complete and timely information.

Source: FR (2007a, p. 33).

[40] IFRSA (2004b, p. 4)
[41] Patterson (2007).
[42] They were subsequently repeated in the FR's Strategic Plan for 2008-2010 (FR, 2007b, p.19). In both the Annual Report and the Strategic Plan the nine principles were introduced as guiding the FR's approach to regulation.
[43] See FR (2006i) for the consumer principles embodied in the Consumer Protection Code. If the nine principles had been formally imposed on all firms in a general code, then the FR would have been committed to take responsibility for their supervision and enforcement. At the same time the code itself would send a strong signal to credit institutions concerning the importance that the FR attached to them in terms of prudential supervision.

flexibility in its application and also permitted the FR to issue Guidelines on the nature of the compliance statement itself and on how managers of financial service providers are expected to exercise control in order to ensure compliance.

4.19 The Authority took a decision at its meeting on 26 November 2004 to prepare a consultation paper on the issue of Directors' Compliance Statements with the assumption that the new requirements would become operational from 1 January 2006. This decision was affirmed at the Authority meeting on 26 January 2005 when it was decided that a public consultation paper should be issued. This did not happen. Instead the FR conducted an informal pre-consultation process during October–November 2006 among selected participants.[52]

4.20 The draft consultation paper noted the importance of Directors' Compliance Statements in fostering,

> —... a culture of compliance by developing a greater sense of accountability and responsibility among company directors and by developing good systems of internal controls within companies so that directors could commit themselves to compliance in good faith. The Financial Regulator attaches great importance to the promotion of a good compliance culture within regulated entities and would wish that this good culture be set at Board of Directors level."[53]

The paper envisaged Directors' Compliance Statements playing a particularly important role as part of theme reviews, follow-up investigations into non-compliance and as a routine, generic periodic requirement to check the compliance culture.

4.21 The informal pre-consultation process involved the Industry and Consumer Panels of the FR as well as five industry representative bodies plus the Chair of AIB.[54] In briefing the Authority, the CEO noted that the resistance to this proposal from industry was very strong. There was a particular concern with the lack of a materiality threshold and it was also suggested that the relevant provisions were unconstitutional.

4.22 The CEO of the FR also reported to the Authority in November 2006 that the Department of Finance, following contacts with industry bodies regarding their concerns, requested that the Financial Regulator not proceed with the consultation

[52] For details see FR (2007a, pp. 76-77). The Directors' Compliance Statements were part of the FR's Strategic Plan for 2007-2009 (FR, 2006b, p. 19), but was missing from the comparable table in the Strategic Plan for 2008-2010 (FR, 2007b, pp. 32-33).

[53] FR (2006e, paragraph 3.1).

[54] Financial Services Ireland, Irish Insurance Federation, Professional Insurance Brokers Association, Irish Brokers Association, and the Irish Association of Investment Managers.

process on the implementation of this requirement without engaging in further discussion with the Department. The Authority was also informed in December 2006 that the Minister for Finance felt that it was important to assess the competitiveness issue.

4.23 Following a discussion with the Department of Finance it was agreed by the FR not to implement the provision as set out in the Central Bank Act, 1997 and to examine the requirement for compliance statements from financial service providers in the context of the project to consolidate and modernise financial services legislation. The FR noted publicly that informal feedback had raised a number of concerns including:

a) the provision contained in the Central Bank Act, 1997 was inconsistent with the Company Law Review Group recommendations;

b) the implementation of the provision would damage competitiveness; and,

c) the application of the provision was not consistent with a principles-based approach.

4.24 However, the Authority could have considered adopting or adapting the revised proposals for Directors' Compliance Statements put forward in the *Report* of the Company Law Review Group.[55] These proposals were designed to ―avoid excessive and costly over-regulation" that might damage competitiveness. Thus, the FR declined to make use of the discretion provided to it by legislation to enhance its principles-based approach to regulation in a way that might have achieved a better balance between the regulator and the firm.

4.25 More broadly, the point here is not really about whether Directors' Compliance Statements should have been introduced and if so what their content should have been. These are matters on which there can be reasonable disagreement. Rather it is to illustrate how an important FR initiative to codify its principles in one respect ran into the sand as the organisation deferred to industry pressure.

- Fit and Proper requirements

4.26 In the 2005 Joint Committee on Finance and the Public Service's (―Joint Committee") *Interim Report on the Policy of Commercial Banks concerning Customer Charges and*

[55] Following representations by businesses questioning the appropriateness, efficacy and proportionality of Section 45 of the Companies (Auditing and Accounting) Act, 2003, the Company Law Review Group was created, which included a representative of the FR. See Company Law Review Group (2005, p. 5, pp. 139-144) for details.

Interest Rates concern is expressed “at the number of incidents in recent years in which banks have failed to comply with acceptable standards of behaviour with respect to prudential consumer and fiscal obligations.”[56] One of the recommendations of the Joint Committee was that the Financial Regulator‘s proposals with respect to fitness and propriety be adopted.

4.27 The fitness requirement meant that the “person appointed as a Director or Manager has the necessary qualifications and experience to perform the duties of that position;” propriety “requires that a person is honest, fair and ethical.”[57] While fit and proper requirements already existed these varied by type of financial institution and in any event needed updating and modernising. Thus the Financial Regulator undertook to modernise the fit and proper requirements for Directors and Managers. Two consultation papers were issued (IFSRA, 2005a; FR, 2006c) before the new fit and proper requirements were issued effective 1 January 2007.[58]

4.28 The updating and modernisation of the fit and proper requirements were related to various inquiries that had been conducted earlier:

> “There has been a renewed emphasis on firms‘ good corporate governance and risk management both domestically and internationally in response to developments in recent years, including the outcome of domestic inquiries and tribunals and international financial scandals. Regulators have been reviewing and updating requirements in relation to corporate governance. Given the importance of the directors and managers of firms in that endeavour, it is timely to review and update fit and proper standards and procedures.”[59]

It should be noted, however, that these fit and proper requirements do not apply to existing Directors and Managers, except when persons change their position.[60]

4.29 The FR did succeed in implementing a standardised approach to fitness and probity applications. This initiative did not, however, extend to placing the fitness and probity

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[56] Dáil Eireann, Joint Committee on Finance and the Public Service (2005, p. 9).
[57] FR (2008a, p. 1).
[58] See, FR (2007a, pp. 73-74) and FR (2008a; 2008b) for details of the questionnaire that has to be completed by those persons wishing to become a Director or Manager and an elaboration of the requirements, respectively.
[59] IFSRA (2005a, paragraph 3.3.2).
[60] Provisions in the Building Societies Act, 1989, as amended, give the power to the FR to remove a Director of a building society for not being a fit and proper person. See, for example, Section 17 of the Building Societies Act, 1989, as amended. This discussion is based on an internal FR memo dated 22 January 2004 prepared by the Regulatory Enforcement Department to the Prudential Director, titled, “Powers under the Building Societies Act, 1989 (as amended) (‘the Act‘).” There was no similar explicit power with respect to banks.

reviews conducted by the FR on a statutory basis for all firms. This has now been proposed in the Central Bank Reform Bill, 2010.

- Corporate Governance Code

4.30 At the core of principles-based regulation is sound corporate governance, defined by the OECD as:

> ―… a set of relationships between a company‗s management, its board, its shareholders, and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining these objectives and monitoring performance are determined, good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently."[61]

Drawing on international best practice the FR prepared in 2005, a *Corporate Governance Guidelines for Credit Institutions and Insurance Undertakings* consultation paper.

4.31 This paper was intended to update and modernise the approach of the CB‗s 1995 *Licensing and Supervision Requirements and Standards for Credit Institutions* (CB, 1995), in relation to corporate governance and to apply that approach both to banks and insurance companies. The importance of the governance paper was set out in the relevant Board Paper considered by the Authority on 25 May 2005:

> ―This paper is being issued at this time because of the significant developments in the area of corporate governance in recent years and to provide a required standard of corporate governance that is consistently applied to all credit institutions. It is also a key milestone in achieving the Financial Regulator‗s second high-level goal, as outlined in the Strategic Plan 2004-2006. It states, ‗***it is our task to ensure that at board and senior management level in each financial service provider, high-level requirements are in place which clearly outline the way business should be conducted and managed***.‗"[62]

The recommendation was to proceed to consultation for a period of six months.

4.32 Before issuing the consultation paper for general comment, the FR decided to conduct a pre-consultation exercise. Twelve credit institutions were asked for their views. The results of this informal consultation exercise were presented to the Authority on 15 September 2005. The relevant Board Paper noted that International Financial Services

[61] As quoted in FR (2006d, pp. 5-6).
[62] IFRSA (2005b, p. 2). Emphasis in the original.

6.17 By this stage, the FSR was including commentary casting a doubt on the warnings of outside commentators[105]. In an article published in the ESRI *Quarterly Commentary* in the summer of 2007, and which had been circulated in draft in February of that year, Morgan Kelly argued that, based on the OECD experience that saw most real house price surges being followed by a sharp fall back, real house prices in Ireland could be expected to fall by 50 per cent. He also noted that while for most economies house building accounted for only five per cent of GDP the figure for Ireland was currently 15 per cent (Kelly 2007a). Although it was not all that far from the scenario painted in the 2004 FSR, Kelly‗s presentation was couched in what was considered by many to be alarmist language and admittedly did not contain an in depth econometric analysis of the Irish situation.[106] But, rather than acknowledging the red flag raised, his paper elicited what now appears as a somewhat defensive response. The 2007 FSR questioned the relevance of the Kelly analysis (Box C, p. 30) as well as the conclusions of somewhat similar studies by the IMF (2003) and OECD (2006a). It was observed correctly that replicating these analyses in terms of nominal (as opposed to real) house prices would not show the same ―reversal to the mean" tendency. However, this conclusion stems from the inclusion in the sample of countries which have typically experienced high general inflation rates; since this is clearly not the case in the euro area the distinction provides little comfort.[107]

6.18 Overall, while the FSR noted the recent fall that had occurred in house prices, quantitative analytical evidence was not provided in support of the key conclusion, namely, that so far as residential property was concerned ―the central scenario is, therefore, for a soft landing" (CBFSAI 2007, p. 17). The likelihood that the drop that had started to take place might be the precursor of a considerably larger fall to come – given the possible extent of overvaluation – was not mentioned.

[105] Earlier (in 2005), the Economic and Social Research Institute had included in its Medium Term Review, a scenario under which Irish house prices would fall by one-third in 2007 (ESRI, 2005).

[106] In a later newspaper article that appeared a week *before* the run on Northern Rock in September 2007, Kelly observed that ―If a crash occurs, or even if already nervous overseas bond holders cut off liquidity to Irish banks … it will be very costly to fix, dwarfing the bail-out of AIB in the 1980s." (Kelly, 2007b)

[107] Apart from looking at nominal prices, the box also noted the important additional fundamental factors typically determining house prices (but did not cite the thorough work of Murphy (2005), which had looked closely at demand and supply factors and found a considerable over-valuation even as of 2004). The box also observes, that ―past international experience may not be an accurate guide to future developments in house prices because the international macroeconomic environment is now somewhat different", i.e., the ―Great Moderation" of reduced international macroeconomic volatility could be expected to continue.

sophistication and rigor across banks.[113] In fact, none of the banks had reliable models, tested and calibrated on Irish data, which could credibly predict loan losses in different scenarios.

6.26 The issue of whether the scenarios represented a sufficient ―turning up of the switches" also deserves attention. In the case of the ―bottom up" exercises, the domestic shock scenarios were derived from considering ―extreme downside risks" in the world economy (CBFSAI 2006, p. 114); in the case of the 2004 exercise, based on historical behaviour, these were chosen to reflect a probability of ―between one in a hundred and one in a thousand of actually occurring" (CBFSAI 2006, p. 106)[114]. A useful complementary approach could have been to apply a significantly more severe macroeconomic scenario to capture, for example, sharper property price falls directly.

6.27 Finally, the presentation of aggregate weighted average results, in particular those of the ―top down" approach, masked differential impacts across individual institutions. The 2006 FSR did indicate that at least one institution‘s capital ratio fell below the regulatory minimum when NPAs more than doubled and the assumed LGD was higher than 25 per cent. However, the more comprehensive data provided to the subsequent Roundtable Discussions with banks in late 2006 (which were not published or referred to in the FSR) revealed a more worrying picture; thus, assuming an NPA ratio of just over 5 per cent, one third of the twelve banks covered fell below the regulatory minimum with a 50 per cent LGD, while this number rose to 9 (representing 88 per cent of total banking sector assets) assuming a 75 per cent LGD. The corresponding exercise described in the 2007 FSR did not contain any references to distributional issues. As already indicated, more coverage of such distributional aspects should and could have been presented in FSRs without compromising the confidentiality of individual institutions‘ data.

[113] For example an internal FR report noted in 2008 that one bank did not have a defined stress testing framework supported by either formal processes or documentation. The bank did not employ an economist and their stress tests did not reference economic data such as GDP, interest rates or unemployment; bank representatives argue that the latter may not be as necessary in the bank‘s case given that they occupied the most profitable economic sector. While the bank did conduct what was referred to as ―ad-hoc stress tests" these appeared to assess the impact of actual events (e.g., the impact of the smoking ban on the pub trade) rather than severe but plausible events.

[114] The shocks in question referred to a 20 per cent appreciation of the euro, a 6 per cent decline in world trade and a 20 per cent fall in equity prices. The biases in using Gaussian distributions to infer tail probabilities for asset price developments were not mentioned.

- Moral suasion

7.3 The concept of moral suasion consists of the central bank/regulatory authority exercising their powers of persuasion – either publicly or privately – to convince financial institutions to modify their behaviour in some desired fashion. Since it does not involve direct interference in an institution‘s lending or other activities it is often considered the most desirable form of intervention, at least as a first step. At the same time, it is recognised that in many circumstances, unless accompanied by a credible threat of more forceful action, moral suasion by itself may not have the desired effect.

7.4 During the period reviewed, as discussed in Chapter 6, successive FSRs expressed concerns publicly regarding the risks to financial stability posed by evolving trends in institutions‘ lending aggregates. Press conferences and public speeches by the Governor echoed these concerns. Nevertheless, these pronouncements stopped short of actually calling on credit institutions to modify their behaviour or indicating that the CBFSAI would consider taking specific steps should they fail to do so.

7.5 However, as a follow up to publication of the FSRs, starting in 2004 **―Roundtable Discussions"** were held annually between CBFSAI officials and senior representatives of the major lending institutions to exchange views on the analysis and messages contained in the Financial Stability Reports.[123] In parallel, the Governor held **meetings** on a number of occasions with the Chief Executive Officers of credit institutions.

7.6 Detailed written records are not available of what transpired during these discussions and meetings.[124] However, based on participants‘ recollections, it appears that the institutions‘ representatives generally speaking took a more sanguine view of the situation and outlook and tended to downplay whatever worries were expressed in the FSRs. It has been suggested by some that the CBFSAI, in these private gatherings, expressed stronger concerns than those conveyed in the public messages of the FSRs. This suggestion has been emphatically refuted by representatives of the institutions

[123] CBFSAI participation was normally headed by the Director General and included the CEO of the FR as well as staff involved in the preparation of the FSRs. The credit institutions were typically represented by their Head of Lending (or the equivalent) and Chief Economist.

[124] In the case of some of the Roundtable Discussions a short summary of the ―Conclusions" is available. However, these tended to echo the main conclusions of the FSRs themselves and did not convey a flavour of any differing points of view that may have been expressed by participants. The CBFSAI Board minutes do not record the meetings of the Governor with the credit institutions.

conducive to promoting the IFSC was considered important by Government.[136] The Department of the Taoiseach took a lead role in coordinating support and the development of the international financial services industry. Partly, this was done through a consultation mechanism, the Clearing House Group at which senior FR representatives as well as industry personnel were present to identify issues of major concern to the development of the sector. The Chair and CEO of the FR participated in several roadshows to promote the IFSC (e.g., Patterson 2007).

7.28 The FR and the CB were mandated by legislation to pursue two goals – financial stability and promotion of the financial sector – which may well have been in conflict. The FR was in a difficult position as the possible adverse effects on discouraging inward investment in the IFSC were more immediate and real than what were perceived as more distant concerns about financial stability. While the stability goal was given explicit priority, the potential conflict between the two goals complicated policy choice.

7.29 A **third** concern was that more aggressive use of some of the instruments discussed above could have been criticised as running contrary to the spirit of principles-based regulation. The latter assumed that financial institutions would at the end of the day operate in their enlightened self interest and that by and large they should be left to so unencumbered by unnecessary, and especially, heavy handed, regulatory intervention. However, such an argument is based on an insufficient appreciation of the risk that poor judgements by decision makers in institutions will lead not only to costs for themselves but also for the wider public given, in many cases, the institutions' systemic importance and the consequent pressures to ―bail them out" to a greater or lesser extent during a crisis.

7.30 As noted in Chapter 4, several key architectural aspects of the principles-based approach had not been applied, or applied only partially, in Ireland since 2003. But even if these elements had been fully in place it would not have protected the financial system from the potential for misjudgement that led to the financial crisis. These misjudgements – in the form of excessive reliance on a massive expansion in property-related lending – were probably facilitated by an incentive structure which, to varying extents, in the face of aggressive competition, tended to reward volume at the expense

[136] For example, ―A number of factors have underpinned our attractiveness as a location for international financial services, including an attractive fiscal and regulatory environment ..." (Department of the Taoiseach, 2006, p. 8). See also *ibid*, (pp. 12-13).

of quality. Strong intervention by the authorities to counteract the possibility that institutions will not take into sufficient account these potential costs to society (often termed ―externalities") and therefore will under-price the risks involved is entirely consistent with the principles-based regulatory approach.

7.31 In addition, even absent the above problems in each individual institution, when the behaviour of all the banks, taken together is considered, systemic financial stability issues may well arise. The fact that loans to overlapping subgroups of the same set of property developers accounted for such a high fraction of credit outstanding from most of the credit institutions implied a systemic risk not captured in risk assessments carried out for one bank at a time. This problem also has cross-border dimensions which are currently the subject of discussions at international level on improvements in information exchange.

Section 4: Conclusions

7.32 Notwithstanding the relatively sanguine message conveyed by successive FSRs, the Central Bank/Financial Regulator could and should have used to a much greater extent the array of instruments available so as to effect a change in institutions' behaviour and thereby reduce substantially the emerging risks to financial stability. Although Roundtable Discussions were held between CBFSAI staff and representatives of credit institutions following the publication of FSRs and the Governor met with CEOs on several occasions, there is no evidence that any stronger warning messages were conveyed during these contacts. Neither was the avenue of writing to the institutions – a practice that had been followed in earlier years – accompanied by a concerted campaign, perhaps in cooperation with the Government, explored. In sum, the moral suasion approach appeared to have been entirely ineffective in terms of inducing any significant change in institutions' lending behaviour.

7.33 The authorities did implement, after considerable internal debate, increases in capital requirements applied to various categories of property-related lending. However, no analysis was undertaken as to what, if any, quantitative impact these measures might have and, even at the time of their introduction, it appears there was a strong element of

CHAPTER 8: CRISIS MANAGEMENT – AUGUST 2007 TO SEPTEMBER 2008

Section 1: Introduction

8.1 After wholesale markets for liquidity started to dry up in August 2007, and especially following the collapse of Northern Rock the following month, the CBFSAI‘s attention began to focus on the liquidity pressures being encountered by the Irish banks and on making preparations for a possible further deterioration in their funding situation. Central banking and regulatory policy in the period between then and the end of September 2008 is considered in this chapter, which is divided into three main parts.

8.2 Section 2 reviews policy actions and planning during this period. Strengths and some shortcomings of crisis preparations are noted. Section 3 focuses on the events of September 2008 as the crisis came to a head, accelerated by the near-paralysis of the international market for short-term liquidity after the bankruptcy of Lehman Brothers (Annex 3), and subsequent events. The discussions leading up to and on the night of 29/30 September are described in this context. Section 4 takes a broader perspective on the guarantee decision, placing it in the context of crisis containment actions taken around that time. It considers whether the guarantee was a reasonable policy response under the prevailing circumstances. Some conclusions follow.

Section 2: Contingency Preparations

8.3 Given the scale of their net international position, the Irish banks were all highly exposed to the disruption in the international market for short-term bank funding from early August 2007 onwards. At first the most conspicuously affected banks worldwide were those who had specialised in buying and re-packaging US mortgage loans, funded through short-term borrowing. The reluctance of wholesale lenders to provide liquidity to these banks (or to the special purpose vehicles which they had created to hold the mortgage-backed securities), reflected: a re-assessment of the likely repayment performance of the underlying mortgages; a realisation that the ratings that had been assigned to the mortgage-backed securities were unreliable and systematically biased towards over-optimism; and uncertainty as to where the worst losses would occur, given the complexity of the packaging and re-packaging involved. Some of the most conspicuously exposed institutions were rescued from collapse early on, including the

German bank Landesbank Sachsen, which had conducted this type of operation, mainly through its Dublin offices.

8.4 Although the main Irish banks had not been much involved in US mortgage-backed securities, they were highly dependent on wholesale funding. The fact that their portfolio was so heavily oriented towards property and that Irish property prices were falling also helped explain why they began to find it harder and harder to attract longer-term funding. But there was also a general world-wide retreat from lending into any type of risk that could not be easily assessed, and the Irish banks suffered.

8.5 As 2008 progressed, liquidity difficulties deepened, especially around mid-March, when the investment bank Bear Stearns was rescued by the US authorities. The share prices of Irish banks also continued to drift lower, a matter which should not in itself be a matter of concern to the Central Bank or Financial Regulator except when, as is nowadays often the case, a share price weakening is taken as a signal by wholesale depositors to withhold their funds.

8.6 Among the actions taken to enhance preparedness were: (i) enhanced cooperation between the CBFSAI and the Department of Finance, via the Domestic Standing Group (DSG) including a crisis simulation exercise; (ii) the preparation of a crisis management manual, including specific institutional issues that arose in light of the Northern Rock collapse[138] and preparation for the possible use of emergency liquidity assistance (ELA); (iii) enhanced monitoring of liquidity flows; and (iv) advance consideration of some practical issues relating to crisis resolution options. These are reviewed in turn.

- Domestic Standing Group

8.7 It is important in any country to have good communication channels between the main public agencies dealing with financial sector matters, namely, the Central Bank, the Financial Regulator and the Department of Finance. Schematically, the FR is the body with the best knowledge of the condition of each of the banks; the Central Bank can form a policy view with regard to the broad financial stability consequences of any given action and is best placed to decide on and implement decisions on the provision of liquidity in the form of short-term loans; while only the Government (represented by

[138] The Northern Rock collapse seems to have greatly influenced the Irish authorities thinking about crisis preparedness and is discussed in Section 4.

Department of Finance officials) can decide on covering underlying losses via taxpayer support.

8.8 In 2006, in line with new EU-wide procedures,[139] an inter-agency financial committee, the Domestic Standing Group, was established to deal, *inter alia*, with crisis management issues. The DSG comprises the Central Bank, the Financial Regulator and the Department of Finance; a Memorandum of Understanding between the parties entered into force in July 2007. The DSG is intended as a framework to help manage financial stability issues, including potential systemic crises. The chair was to be rotated among the three parties on an annual basis. It could meet at various levels. Typically at the early stage, envisaged participants would have included the Assistant Director General, Economics (Central Bank), the Prudential Director (Financial Regulator), and an Assistant Secretary (Department of Finance). From mid-2008 the group has also met as needed at the level of Governor, CEO (FR) and Secretary General or Second Secretary (Department of Finance). In addition, during this period, the NTMA participated. At the outset, the work program of the DSG included:

- exchanging information on market and regulatory issues;
- overseeing the updating of the crisis management manuals of the CB, FR and Department of Finance;
- participating in crisis simulation exercises;
- developing principles for the resolution of financial crises, taking account of work being done at the EU level;
- policy and procedural issues relating to deposit insurance; and
- examining the impact of company law provisions on insolvency in crisis situations.

- The Crisis Management Manual (also known as the Black Book)

8.9 The Black Book (prepared initially in 2001) in its original form included:

- the principles under which the Central Bank would operate during a crisis;

[139] In recent years, under the auspices of ECOFIN, there has been an increasing focus on developing co-operation between the relevant authorities in order to help manage cross-border crisis-related issues within the EU. In 2003 an MoU was agreed between all banking supervisors and central banks in the EU. A tripartite MoU involving ministries of finance as well as supervisors and central banks, followed in 2005. A number of European-wide crisis simulation exercises were conducted involving central banks, supervisors and ministries of finance. These were based on the potential consequences of an assumed failure of only one institution and did not address the possibility of a crisis affecting several institutions simultaneously. Therefore they turned out to be not particularly useful in the Irish crisis situation.

- operational procedures and terms and conditions for ELA;
- legal issues relating to insolvency laws and state aid to industry; and
- information and logistic issues such as arrangements for contacting the responsible persons in a crisis.

8.10 Following the experience of the UK authorities, close attention had been given to provision, if necessary, of ELA by the Central Bank. In the Eurosystem, this form of financial assistance may be used in the case of a solvent but illiquid credit institution which does not have sufficient collateral with the required characteristics for use in normal ECB lending operations. Such assistance can only be given on the basis of adequate alternative collateral and the associated credit risk is assumed by the national central bank and not the Eurosystem as a whole. The assistance is provided at a penalty rate of interest and is envisaged to be used only in an emergency and for a very short period. Following extensive work on the legal documentation and decision-making powers involved, the detailed procedures were presented[140] to the CBFSAI Board in November 2007 which approved the delegation of powers to the Governor with respect to the granting of ELA.

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

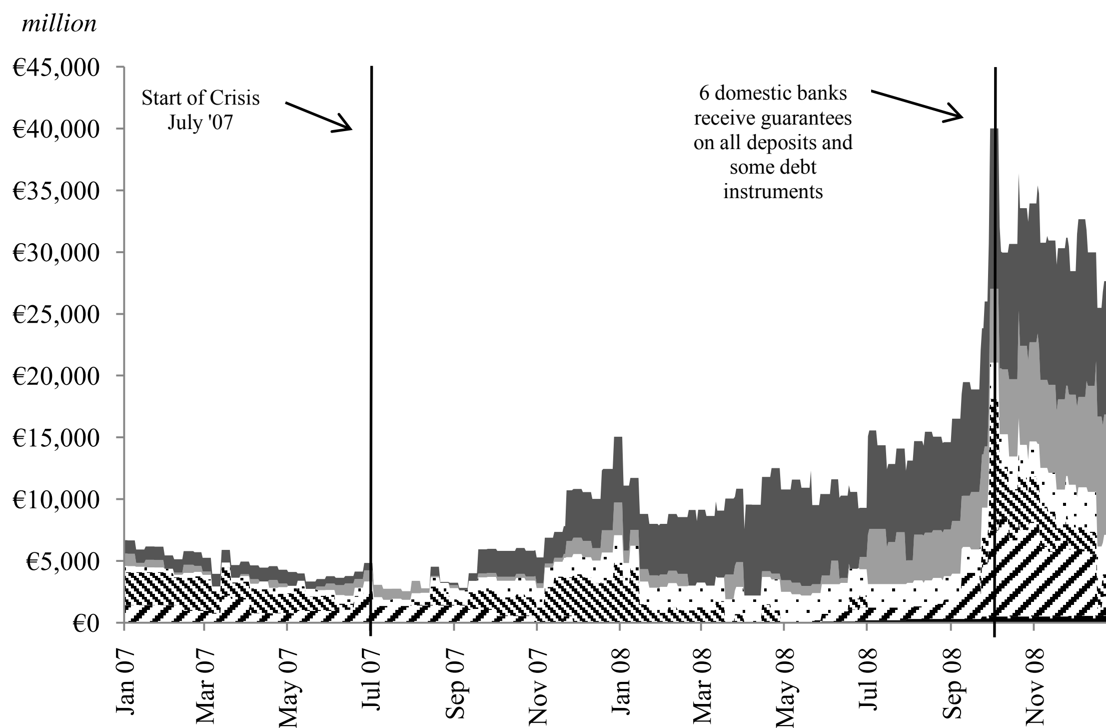
- Monitoring of liquidity flows

8.12 A Liquidity Group chaired by the Deputy Director General of the CB was established in early 2008 to obtain and disseminate information on liquidity developments from the main credit institutions and to identify any potential problems at an early stage. The group met at least weekly and shared data on the sources and maturity structure of funding, the bidding behaviour in Eurosystem operations which provided some idea of the liquidity needs of institutions participating in ECB refinancing operations, the use of collateral, fulfilment of the minimum reserve requirements of the ECB, interbank transactions and the likely observance of prudential liquidity ratios. While this exercise proved to be a valuable tool in helping to establish a ―real time" picture of liquidity

[140] CBFSAI Board Paper No 151 of 2007, *Liquidity Management Procedures*.

developments during the turmoil, a comprehensive, daily picture of the actual liquidity flows had not been put in place before early 2009. During 2008, the liquidity situation deteriorated, as reflected in the unprecedented recourse to financing from the European Central Bank which rose from a monthly average of around €6 billion in September 2007 to €20 billion in September 2008 (Chart 8.1).

Chart 8.1: Refinancing Operations by the ECB for the Covered Institutions – January 2007 to December 2008



- Crisis containment options

8.13 A paper entitled Crisis Resolution Options[141] was discussed by the DSG in mid-2008. It reviewed the possible procedures and potential pitfalls involved in dealing with a troubled bank or building society. Two main crisis options were considered, namely assisted private sector acquisition and nationalisation (other possibilities briefly considered in an earlier draft included use of ELA, alternative mechanisms for providing liquidity, for example by investing (against collateral) some of the liquid assets of the NTMA, and a blanket guarantee). However, the paper offered little detail about implementation of the various options including that of the issuance of a guarantee (for example, it did not address the question of possible inclusion of

[141] Crisis Resolution Options, 11 June 2008: Financial Stability Department and Banking Supervision Department, CBFSAI.

subordinated debt)[142]. The note concluded with a series of recommendations requiring additional legislative work, including on nationalisation and resolution regimes. In the event, work was not pursued further at this stage and the paper's content appears to have been quickly overtaken by events.

8.14 In the case of private sector acquisition, the paper favoured, for operational reasons, implementing such a decision during a weekend. It sketched out the main steps that might be involved, including the possibility of temporary funding, perhaps via ELA. The paper argued that the alternative option of temporary nationalisation[143] should be considered only when all private sector solutions were exhausted. In this case, shareholders would not be bailed out and creditors and uninsured depositors should expect losses. Given the lack of a banking resolution framework, there was concern that simply announcing a nationalisation might not stop a run on the bank. Important elements that might be considered included a guarantee to prevent a run on the bank (although no details of such a guarantee were provided[144]), a trigger point for action by the authorities and provisions that would be necessary to avoid the immediate payment of a troubled institution's debt securities.

- Assessment of preparations prior to the crisis peaking

8.15 While considerable effort was thus devoted to preparing for a liquidity crisis, this period was also noteworthy for the unravelling of the Quinn-Anglo CFD affair, which was not ultimately resolved in a satisfactory manner.[145] This appears to have represented a major preoccupation for the Authority at a crucial time. It should be emphasised that because of the information gap discussed in previous chapters which acted as a blinker, at no point in this period was it thought by the authorities that any of the banks were

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[142] As mentioned below, a more detailed discussion of options was prepared for the Department of Finance by Merrill Lynch – who had been engaged as consultants by the NTMA/Department of Finance in early September – on the weekend before the guarantee.

[143] It was not made explicit why this would solve the problem. (If the assumption was that government ownership was, by itself, a sufficient assurance to lenders, then this would not have been borne out by a comparison with the US, where very many insolvent banks have been taken under the control of the FDIC without all lenders being made whole.)

[144] A later note, undated but understood to have been prepared in the last days of September, drew on the June paper. It added a small but significant detail on the guarantee, specifically envisaging that such a guarantee would cover both senior and subordinated debt.

[145] As this matter is the subject of separate investigations, and does not centrally affect the conclusions of this report, it is not considered further here.

facing imminent underlying solvency risks.[146] This had the consequence that no attempt was made to urge the banks to raise – or even conserve – capital.[147]

Section 3: The Policy Discussions of September 2008

8.16 The publication of a very adverse rating agency report on INBS[148] on 5 September 2008 heralded the final stage of the run-up to the guarantee. More frequent and higher level meetings between the agencies represented in the DSG (with the NTMA), took place imbued with a growing sense of urgency.[149] The Department of Finance took a clear leading role at this stage (with the CBFSAI playing a less central role than might have been expected), commissioning consultants and advancing preparations for legislation to nationalise a bank and/or a building society and to provide an extensive guarantee of banking liabilities. The diminishing access of banks to liquidity was now an urgent focus of attention. While the INBS story had heightened concern, it was generally understood that it was Anglo Irish Bank that was most vulnerable on a week-to-week basis, depending in particular on how much of its maturing deposits would be rolled-over. Consultants were engaged to scrutinise the condition of INBS and Anglo.

8.17 As the discussions regarding procedures for crisis containment started to unfold, early on a clear consensus view emerged that **no Irish bank should be allowed to fail,** in the sense of having to close its doors and not repaying depositors and other lenders. This strong view departed from the textbook view that only systemically important institutions should be candidates for such protective treatment. (See below for a further discussion of systemic importance.) But it was shared without reservation by all the

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[146] Even executive directors of Anglo Irish Bank seem to have had no inkling of the problems to come if we are to judge from the fact that three of them acquired and held sizeable blocks of shares in the Bank close to the peak of its share price in 2007.
[147] Indeed, during the first nine months of 2008, Anglo paid out €0.14 billion in dividends, Bank of Ireland €0.39 billion, and AIB €0.72 billion – of which €0.27 billion was paid out as late as 26 September 2008, four days before the guarantee.
[148] A report by Reuters on 5 September indicated that, following a credit downgrading by Fitch, INBS had entered talks with its lenders to avoid insolvency. The report, which was subsequently withdrawn, appeared to reflect particular market concern about the widely publicised extent of INBS's property exposure. The Authority quickly issued a strong public statement denying the content of the Reuters statement. However, both the CB and the FR recognised that if the liquidity situation were not to improve serious thought would need to be given to the possibility of nationalisation using the draft contingency legislation prepared beforehand. In the event, the outflows of certain types of wholesale funding ceased over the following weeks and since much of the rest of INBS's resources were in the form of customer deposits that were considered relatively stable – partly due to the long-held expectation that the society would be de-mutualised providing a windfall to members, the liquidity situation became manageable. Thus, the nationalisation option did not resurface for INBS.
[149] The Governor was convalescing from an operation earlier in the summer and returned to duties only in mid-September.

key officials involved and, for good or ill, simplified the decision making process. By late September, it would have also reflected the broader reaction at European level to what was considered to be an ill-judged policy decision on the part of the US authorities not to save Lehman Brothers.

8.18 A detailed review of the ensuing discussions is hampered by the absence of an extensive written record of what transpired.[150] Although the minutes of meetings of the CBFSAI Board and the Authority during the period contain references to various options, there is an absence of documentation setting forth the advantages and disadvantages of possible alternatives and their quantitative implications. While CBFSAI Board members expressed some broad views on possible approaches, no decisions were taken, as the solutions would need to be found at Governmental level. The key discussions took place via the very many informal contacts and meetings between senior officials of the DSG agencies, the NTMA, and consultants; what follows relies to a very large extent on the personal recollections of participants.

8.19 Throughout this period – up to and including 30 September – as noted above, the clear consensus was that the problem was essentially one of liquidity rather than of solvency. (See Box 8.1 for a discussion of these concepts.) While some doubts may have been felt or expressed privately, the minutes of the CBFSAI Board and Authority meetings do not record any concerns as to possible underlying weaknesses of the various institutions which were believed to be suffering the consequences of a world-wide "financial tsunami". Thus the comforting reassurances provided to the CBFSAI Board and Authority on earlier occasions that there were no fundamental problems were not put into question.[151]

[150] Only sketchy records appear to have been kept of the intensive round of informal meetings in the days and weeks prior to 29 September or of the events of that night itself. Although recognising the severe pressures of rapidly unfolding events, greater transparency with respect to the unprecedented decisions being considered and their far reaching implications would have been desirable.

[151] While many banking observers were becoming increasingly concerned about the long-term prospects of Anglo (the institution under most pressure throughout September), given its business model based on wholesale funding for on-lending to property development, and some loan losses were clearly in prospect, neither the FR staff nor consultants engaged envisaged Anglo being insolvent.

Box 8.1: Liquidity versus Solvency

The average maturity of a bank's borrowing is typically shorter than the average maturity of its assets. Indeed, this maturity transformation is a valuable function that the financial system as a whole performs for society, allowing savers to have ready access to funds, while facilitating the financing of productive activities that take a long time to prepare and bring to fruition. A bank manages the risk that too many of its lenders will look for their money all at once by holding cash reserves, and by turning to the money markets for short-term borrowing. For fifty years Irish banks had no difficulty in accessing any short-term funding they needed. Liquidity was thus not a problem. However, after August 2007, and especially after the events of mid-September 2008 in the US, the access of banks worldwide to short-term borrowing became very constrained because of the heightened risk aversion and the uncertainty about the solvency of all financial institutions and about the willingness of governments to bail out insolvent banks.

It is in such circumstances that one can speak of a bank being solvent – in the sense that its assets will, *when they mature*, provide more than enough to repay those who have lent to the bank – while at the same time being illiquid – in the sense that the bank is unable to repay its borrowings *immediately* and cannot find other lenders who can tide it over. Obviously, putting a solvent but illiquid bank into bankruptcy is unnecessarily costly for society which is where emergency liquidity assistance (―lender of last resort") from the central bank arises. The emergency loans should be made at a penalty rate so that banks have an incentive to avoid getting into a situation of illiquidity. However, the main difficulty lies in determining whether the bank really is solvent. For this, one cannot rely on what will all too often be a self-serving and over-optimistic assessment from the troubled bank. Instead, the regulator must have assembled the necessary information and analysis to provide the needed advice.

8.20 Apart from the focus on liquidity issues, discussions were informed by the underlying principle – referred to earlier – that no Irish bank would be allowed to fail. In addition, it became apparent from informal contacts that notwithstanding the general turbulence, there was at that stage no European-wide effort under way to mount an initiative to help distressed institutions. Thus, each national authority would have to take whatever measures might prove necessary to deal with its own situation.

8.21 September progressed without any respite from the liquidity pressures. Following media coverage, including on a popular radio programme (*Liveline* on RTE), warning of a possible run on the banks, on 20 September the limit under the deposit guarantee scheme was raised from €20,000 to €100,000, and the coverage increased from 90 per cent to 100 per cent within that limit; and the Government issued a statement affirming its resolve to stand behind the banking system. While these actions helped forestall possible panic on the part of retail depositors they appeared to have little or no effect in stemming wholesale deposit withdrawals.

8.22 As the liquidity situation continued to deteriorate (especially the shortening of maturities), several specific options were discussed. First, for some time consideration had been given to whether legal powers existed to establish a domestic Secured Lending Scheme (―SLS") drawing on some of the CBFSAI's investable financial assets, together with contributions from the NTMA and/or the Pension Reserve Fund; a total of about €20 billion was mentioned, with about half of that to come from the CBFSAI. A variant/possible complement to this approach was the issuance of a State bond which could be used as ECB-eligible collateral by domestic banks. Some preparations along these lines were made. However, this approach was seen as having several shortcomings: first, the providing entities would be exposed to potentially serious financial risks (in particular the CBFSAI has only a small buffer of capital reserves); second, there was no certainty that the sums being spoken of would be sufficient to ―stem the tide"; and third, issues might be raised at the European level as to whether this could be construed as the provision of state aid and/or, in the case of some components, ELA under another guise.

8.23 Second, the use of ELA itself was discussed.[152] While this would have had to be notified to the ECB, and any significant amounts would have required prior agreement (strictly speaking: no objection) by the ECB Governing Council there is no reason to believe that this would not have been forthcoming. However, it was observed that ELA was normally intended to be availed of in the case of a single institution facing difficulties. Using ELA to support the entire banking system – which might end up being necessary – could, it was thought, have had a major adverse reputational impact on the Irish banking system. More generally there was uncertainty whether use of ELA, if publicly disclosed or detected (as would be likely), would boost or detract from market confidence. Finally, as with the SLS option above, the potential open ended size of the operations and the associated balance sheet risk for the CBFSAI were seen as serious concerns.

8.24 As the crisis worsened and the unprecedented scale of the problem loomed larger the above possibilities were not pursued further. In the days before 29 September, the CBFSAI Board and Authority met on a number of occasions and more far reaching

[152] Provided a bank has eligible collateral, liquidity may be accessed via refinancing operations with the ECB. However, in the absence of ECB-eligible collateral an institution may, as indicated earlier, apply for emergency lending assistance from the CBFSAI.

options began to surface, in particular the proposal for a comprehensive or blanket State Guarantee. No clear consensus emerged; however, Board members indicated that the Governor of the CBFSAI and the Chair and the CEO of the Financial Regulator had their full support ahead of what were expected to be intensive discussions with the Government.[153]

8.25 On Sunday, 28 September, it was thought that Anglo would be able to survive the full week. The focus in Dublin that day was on the acute liquidity pressures facing Depfa bank, by then an Irish subsidiary of the German bank Hypo RE. But the weekend‘s events in other countries (Annex 3) shook markets. With Anglo Irish Bank‘s shares collapsing on the Monday[154] – indicating a general loss of market confidence in its survival – and its apparent inability to replace further liquidity withdrawals, it became clear that Anglo could not survive another day. Decisive action that evening was inevitable and the top officials from the agencies prepared for another round of meetings.

8.26 That afternoon, the two main banks, Bank of Ireland and Allied Irish Banks (AIB), also came to the conclusion that decisive and immediate action by Government was called for. They foresaw otherwise the imminent collapse of Anglo Irish Bank – in effect its inability to meet its immediate payment obligations. Such an event would be devastating for all the remaining Irish banks, and result in an accelerated outflow of funds which, although neither of them was at that point close to having exhausted its eligible collateral, would nevertheless quickly bring them also to the edge. At their coordinated request a meeting with the Taoiseach and the Minister for Finance was set for later that evening.

8.27 There followed an all-night sequence of meetings, led by the Taoiseach and the Minister for Finance, and involving the Attorney General, and senior officials from the Departments of Finance and the Taoiseach and the CBFSAI; senior officials from the NTMA were also present for some of the discussions.

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[153] On 25 September the last Board meeting of the Central Bank prior to 29 September, the minute recorded a request from the Department of Finance that the Governor provide a formal view on the situation to the Department of Finance. In the event, on October 18, the Governor wrote to the Minister of Finance indicating his full support for the 29 September decisions.

[154] The share price closed on Monday at €2.30, compared with €4.28 on the previous Friday.

8.28 The main outcome of the meetings is well known: a blanket guarantee but no immediate nationalisations. For present purposes it is appropriate to focus on the views of the CBFSAI representatives and the banks on the main issues.

8.29 The Governor and DG of the Central Bank and Chair and CEO of the FR participated in some of the meetings that evening. Before the meeting they had all, with varying degrees of enthusiasm, come to the conclusion that a general guarantee was necessary and unavoidable. The question of nationalisation of Anglo Irish Bank and an associated change in management was also on the table. Among the reservations expressed by CBFSAI participants were fears as to how the market might react to such a move, and concerns about the operational risks involved in trying to nationalise mid-week (i.e., the matter could be deferred to the weekend if it still proved to be necessary).

8.30 The two banks (each of whom was represented by their Chair and CEO) only participated in two meetings with the Taoiseach and Minister. In the first of these they indicated that they favoured both an immediate general guarantee (including subordinated debt) and the nationalisation of Anglo Irish Bank (and possibly INBS). Their motivation for urging nationalisation was that this would remove these institutions' negative reputational effect on Irish banking generally. All concerned agreed that the banks did not participate in the subsequent discussion on what action should be decided upon.

8.31 The second meeting involving the banks occurred after the guarantee decision had been taken; the banks had been asked earlier whether they could provide an immediate short-term liquidity facility to Anglo Irish Bank, and (after eliciting what was technically feasible with their staffs) they indicated that each of the two banks could speedily make a total of €5 billion available for a matter of days, provided it was covered by a Government guarantee. It may be noted that neither of the banks gave any thought to involving Anglo representatives in considering their approach.

8.32 It was also agreed that the CBFSAI would make an amount of up to €3 billion available via an asset swap *vis-a-vis* Anglo Irish Bank, €1 billion of it the following morning. In the event, the strong reflow of funds in the following days made the banks' special

liquidity facility unnecessary and it was not drawn upon;[155] nor, was the CBFSAI funding. The question of nationalisation also evaporated by the following weekend.

8.33 Some of the parameters of a guarantee scheme had already been aired in discussions over previous days. These had to be finally decided now. One issue was the coverage of the guarantee. Apart from exclusion of shareholder funds, the question arose as to whether or not to include subordinated debt. Given that the whole point of subordinated debt is to be a form of risk-absorbing capital, and as such is sold as being explicitly more risky than senior bonds, it would have been reasonable to argue that subordinated debt holders should not be exempt from possible losses; as far as can be determined, no guarantee offered by any other government during the crisis covered such risk-bearing liabilities. The note prepared the previous weekend by the Merrill Lynch advisers had explicitly envisaged exclusion of dated subordinated debt from the coverage. The banks might benefit from inclusion, to the extent that their ability to issue new subordinated debt in the future would be hampered otherwise.[156] It was apparently also argued that, since many of the subordinated debt bond holders were also holders of Government Paper, their exclusion could adversely affect Ireland's debt rating. There was also concern that anything short of a comprehensive, simple to understand concept might cause confusion when markets opened and undermine the effectiveness of the Government's action. CBFSAI representatives did not challenge these propositions. In the event, it was decided to include dated, but not to include undated (perpetual) subordinated debt.[157]

8.34 Two other issues arose (apart from the duration of the guarantee for which the period of two years was quickly decided upon as beyond the likely duration of the prevailing market pressures). First, how much should the banks pay for participating in the scheme, given that – as had been rightly pointed out by Merrill Lynch in their options note – the sovereign credit rating, and hence the cost of borrowing, would likely be affected by the contingent liability (estimated at over €400 billion) associated with the

[155] The funds were already placed by the banks with the Central Bank.
[156] No new money has, however, since been raised through subordinated debt by any Irish bank (although there have been a number of debt swaps).
[157] Some of the dated subordinated debt had clauses permitting (but not obliging) the issuing bank to redeem it within the two-year period. In normal times, such debt is almost always repaid at the first permissible date, with the result that it would be seen as a sign of weakness for an issuing bank not to do so. There appears to have been some confusion about this issue on the night of 29/30 September, with some participants understanding that some or all of the dated subordinated debt would fall due before the end of the guarantee (see Annex 4).

guarantee. Second, what conditions (for example, as regards Government having a say in bank remuneration) would be associated with the scheme. While some informal discussions with bank representatives on these issues took place on the margins of the meetings, both aspects were left to be worked out later in the context of implementing legislation to follow shortly.

8.35 Prior to the announcement early in the morning of 30 September, both the ECB and the EU were informed of the Government‘s action. Some concerns were expressed bilaterally as regards the lack of international consultation prior to the Irish decision and the effect that it might have on flows of funds internationally. On the Irish side, participants have emphasised that given the very short time available prior to the opening of the markets, absolute priority had to be given to finding a solution which would ward off the possible imminent collapse of the domestic banking system.

Section 4: The Appropriateness of the Guarantee

8.36 Was the guarantee, backed as it was by the CBFSAI, the most appropriate policy response in the circumstances? Three specific aspects are addressed: namely, (i) the scope of the guarantee; (ii) the treatment of Anglo Irish Bank; and (iii) the extent of consultation with partner EU countries.

8.37 Before considering these issues it is important to recognise that the Irish decision was taken, not only in the face of a potentially disastrous situation at the heart of Ireland‘s banking system, but against the background of a bewildering sequence of bank failure events internationally (Annex 3). What is striking is the variety of policy measures that were employed. Some financial firms were nationalised in full or in part, some part-nationalised, some assisted with loans, both long-term and short-term, some were intervened with losses imposed on debt holders and large depositors while insured depositors were made whole, some were offered a priced guarantee for new borrowings, some were bankrupted. After the bankruptcy of Lehman Brothers, governments became increasingly concerned to avoid the collapse of another systemically important financial firm, and the interpretation of what was systemically important tended to become more lenient, given the fragile nervousness of financial markets. Even in the United States, which had extensive experience of closing banks and imposing losses on uninsured depositors and other creditors, and an impressive set of legal powers to do so,

policy makers became more cautious and began to rely more on open bank assistance of some form (Box 8.2).

Box 8.2: Recent Bank Closure Policy in the US

The experience of the US is often pointed to by advocates of bank closures. And indeed, with its very large number of mostly small banks, the United States has been the main laboratory of bank closures over many decades. The authorities have generally followed that classic rule: a bank that is solvent but illiquid (in the sense explained above) should be granted emergency liquidity by the central bank. But an insolvent bank should be intervened and wound up (unless it is systemically important, or unless a lower cost solution for the deposit insurance fund can be found). Then the insured depositors are paid from the deposit insurance fund and the other creditors paid out of the proceeds of the liquidation in accordance with their priority in law. Of course, in the United States, the very generous ceiling on deposit insurance cover ($250,000) and the large number of banks, combined with an efficient system of mortgage brokerage, means that most large retail depositors can and do spread their deposits between different insured banks with the result that – except in large banks – relatively few individual deposits exceed the covered ceiling. Partly for this reason, it is currently proving cheaper in most cases for the FDIC to sell the whole deposit book and part of the assets of a failed bank to a strong competitor, rather than simply paying off the insured depositors.

In dealing with the creditors of insolvent banks, the Federal Deposit Insurance Corporation (FDIC) has greater ability to differentiate between the claims of different creditors thanks to the fact that there is special resolution legislation in the United States for banks giving it such powers to alter the priority of bank creditors in an insolvency.

Since the end of September 2008, over 200 banks in the US have been closed. Most of these were very small – just a few hundred million in assets – but half a dozen were $10 billion or more. Despite the energy and experience of the FDIC in monitoring insured banks, and its statutory obligation to intervene whenever it becomes aware of the bank's capital dipping below a certain figure, the FDIC generally incurs a loss on these resolution activities. For the six largest banks, the FDIC incurred an estimated aggregate loss of $15 billion in paying out on $70 billion of deposits. Other non-deposit creditors in these banks lost out.

But for larger, systemically important banks, such as Citi, alternative approaches were employed, ensuring that creditors of such large banks did not suffer because of the wider implications for the functioning of the payments and economic systems and ultimately the need to ensure that the banking system could reliably perform the task of transferring ownership claims with legal certainty.

8.38 No other country had introduced a **blanket, system-wide, guarantee**, though this has been a relatively frequent tool in previous systemic crises (Box 8.3). As such, the Irish guarantee caused considerable waves, upped the ante for other governments struggling to maintain confidence in their own banking systems, and placed some direct competitive funding pressure on banks in the UK, where the liquidity position of some

leading banks was much more critical than was known to the Irish authorities at the time.

8.39 The scope of the Irish guarantee was exceptionally broad.[158] Not only did it cover all deposits, including corporate and even interbank deposits, as well as certain asset-backed bonds (―covered bonds") and senior debt it also included, as noted already, certain subordinated debt. The inclusion of existing long-term bonds and some subordinated debt (which, as part of the capital structure of a bank is intended to act as a buffer against losses) was not necessary in order to protect the immediate liquidity position. These investments were in effect locked-in. Their inclusion complicated eventual loss allocation and resolution options.[159] Arguments voiced in favour of this decision, namely, that many holders of these instruments were also holders of Irish bonds and that a guarantee in respect of them would help banks raise new bonds are open to question: after all, extending a Government guarantee to non-Government bonds has the effect of stressing the sovereign to the disadvantage of existing holders of Government bonds; besides, new bonds could have been guaranteed separately. The argument for simplicity also is weakened significantly by the fact that an actual dividing line between covered and non-covered liabilities was drawn at as least an equally arbitrary point; moreover, such instruments were held only by sophisticated investors.

8.40 Subordinated debt holders have suffered some losses, given the buy backs that have occurred at discounted prices.[160] Nevertheless, the inclusion of existing debt in the coverage of the guarantee likely increased the potential share of the total losses borne by the State. This eventuality deserved fuller consideration in advance.

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[158] And much broader than that offered by the UK authorities in the case of Northern Rock one year earlier, a case which had formed the backdrop to much of the Irish planning (see Box 8.3)

[159] For example, if the US authorities had decided to impose losses on debt holders in additional major banks during 2009, this would have altered the market context by setting a new standard for loss-sharing in a way that the guarantee might have made difficult to emulate.

[160] Losses of €5.1 billion have been realized by subordinated debt holders of the three largest banks to the time of writing. This estimate is not greatly altered if an allowance is made for the use of high coupons on some of the debt provided in some of the exchanges. In the case of Anglo Irish Bank, the realized loss is €1.2 billion out of an initial €4.9 billion at end-September 2008. Applying current market prices to the remaining €2.1 billion of nominal sub debt in this bank would entail an unrealized mark-to-market loss of approximately €1.2 billion.

Box 8.3: Northern Rock – Similarities and Differences *vis-a-vis* the Irish Guarantee

The experience with Northern Rock seems to have coloured the thinking of many official participants in the decisions of end-September 2008. It is useful to sketch some relevant aspects.

Before the collapse of Northern Rock one year earlier, it is probably fair to say that most individual bank depositors in Western Europe assumed that their bank deposits were not only perfectly safe, but fully guaranteed by Government. If the first might not have been completely true, the second most certainly was not.[a] It was only in 1989 that the Irish Deposit Guarantee Scheme (DGS) was introduced, at first covering only £10,000 of the first £15,000 of any individual depositor‗s loss.[b] (The DGS, which is a permanent statutory scheme, now fully covers deposits up to €100,000, following the latest increase in coverage announced in mid-September 2008).

This misapprehension became clear during the Northern Rock bank run of September 2007. Northern Rock was a Newcastle-upon-Tyne based bank (formerly a building society) which had specialised in aggressive mortgage lending financed through short-term wholesale borrowings channelled through special purpose vehicles. When its wholesale funding dried up, it received emergency liquidity assistance from the Bank of England, eventually amounting to £27 billion – a world record at the time. Announcement of the provision of ELA triggered a retail depositor panic and long queues formed outside Northern Rock branches from 15 September 2007, including in Dublin. On 20 September the UK Treasury announced guarantee arrangements – including for Irish depositors – which covered existing deposits in Northern Rock (and accounts re-opened by those who had closed them in the previous week). The guarantee was to remain in place ―during the current instability in the financial markets" and was eventually withdrawn on 24 May 2010. Although the trigger for the guarantee was the sight of retail depositors queuing, much of the initial liquidity pressure on Northern Rock related to a withdrawal of wholesale funding.[c,d]

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

The Northern Rock guarantee did not explicitly extend to other banks – at the time no general market concerns were present – but it may have been taken as an implied guarantee, in that it revealed to the market the reluctance of the UK Government to let a medium-size bank (total assets were around £100 billion compared to Euro 100 billion for Anglo Irish Bank) fail.

Although Irish officials often refer back to the Northern Rock experience, the Irish guarantee differed in a number of important respects.

First, it was not preceded by a *retail* depositor run of any significance; instead it reflected a silent *wholesale* run, mainly on Anglo Irish Bank (which was facing imminent default on its obligations), but on other Irish banks also.

Second, the Irish guarantee covered not only retail and wholesale deposits and other short-term borrowing, but also almost all of the bank‗s uncollateralised long-term debt including much of the subordinated debt. Only the undated (perpetual) subordinated debt was not covered. It also applied to existing, as well as new debt, even though holders of long-term debt maturing outside the guarantee period could not withdraw their funds in this period.[e]

Third, and most important, the Irish guarantee was in effect a blanket system-wide guarantee (though not in practice covering foreign-controlled banks). Blanket deposit guarantees have been a relatively common feature of systemic banking crises of the past,[f] reflecting the concerns of governments that bank depositors will have an unfounded but hard-to-dispel fear that known solvency problems at one bank could imply problems at others.

Studies have shown that blanket guarantees have typically been associated with crises that resulted in larger fiscal costs which in turn reflected the underlying gravity of the situation that called for such a drastic step. However, there are indications that a regime that is prone to introducing a blanket guarantee is also more likely to have been associated with less adequate regulation that can result in large banking and fiscal losses.

[a] While the US FDIC was created in 1934; the first nationwide scheme in Germany dates to 1966, in France and the UK to 1980; and in Italy to 1987 (Demirgüç-Kunt, Karacaovali, & Laeven, 2005).
[b] Depositors in Irish Trust Bank, which failed in 1976, were ultimately compensated by the Exchequer which provided £1.8 million to do so.
[c] Retail and wholesale funding fell by £14 billion and £18 billion respectively in the second half of 2007.
[d] Northern Rock was taken into temporary public ownership in February 2008. This whole experience focused the attention of the UK authorities on the need for a special resolution regime to enable them to deal promptly with a failing institution; such legislation was enacted in February 2009.
[e] Except in an event such as liquidation, at which point they would now be covered by the guarantee.
[f] They were introduced in 15 of 42 recent crises studied (see Laeven and Valencia, 2008) Such guarantees have been introduced both in cases where there were existing limited deposit insurance schemes and where there was no prior scheme. In most cases the guarantee was introduced after several months of crisis, and many such guarantees remained in place for a long period, for example for between 6 and 9 years in the cases of Finland, Indonesia, Japan, Malaysia, Mexico and Thailand.

8.41 **Turning to the question of Anglo Irish Bank**, in normal times, policy should not exclude the possibility that a small failed bank should be wound-up with losses to uninsured creditors. But in times of heightened risk aversion and uncertainty, the failure of even a medium-sized bank can have wider confidence implications of such severity that a rescue or bailout is the optimal public policy. More generally, a bank that might be a candidate for a bailout is generally termed ―systemically important" – though it does not follow that all systemically important banks should be saved. Given the increasingly tense confidence situation in the weeks after Lehman‘s, the failure of almost any bank began to be seen by European policymakers as something to be avoided at almost all costs.

8.42 A question that has been the subject of considerable discussion following the guarantee decision is whether the authorities should have allowed a disorderly bankruptcy of Anglo Irish Bank or bailed it via the guarantee. As is confirmed in Box 8.4, which sets out current international thinking on what makes a bank systemically important, Anglo was clearly systemically important in the prevailing conditions at the end of September 2008

Box 8.4: Was Anglo Systemically Important?

A question frequently raised is whether it was correct to consider Anglo Irish Bank to be a systemically important bank. If not, it could be argued that its bankruptcy should be tolerated, even if losses were imposed on uninsured depositors and other claimants. To be sure, this bank was the third largest Irish-controlled bank in terms of its total balance sheet, and for a time in 2008 even became the largest bank by market capitalisation on the Irish Stock Exchange. But it was far from being a household name, had a branch presence in only six cities in Ireland and measured by employment and number of borrowers, was outstripped by several other institutions. Inasmuch as it had grown twenty-fold in a decade, the Irish economy had prospered without much overall contribution from it in the 1990s. It was not central to the payments system or involved in a large range of complex money market transactions with other financial market participants.
Nevertheless, as a recent paper prepared for the G20 clearly recognises, a judgment about systemic importance ―is time-varying depending on the economic environment... It must also be conditioned by its purpose—whether it will be used for example, to define the regulatory perimeter, for calibrating prudential tools including the intensity of oversight, or to guide decisions in a crisis." (IMF et al., 2009) It is the final aspect that is most important for the current discussion.

Three criteria are generally considered according to which a financial institution can be viewed as systemically important, namely: size, inter-connectedness, and substitutability. The preceding discussion suggests that Anglo Irish Bank would be unlikely to satisfy the substitutability criterion (i.e. is there another institution that could perform the same functions) and might not even satisfy the size criterion, even at its peak. But its interconnectedness *vis-a-vis* the Irish banking system changes the story. Given what was happening in the US and European banking markets around that time, the survival of even long-established and relatively highly rated banks (such as RBS, HBOS, Lloyds, Bradford and Bingley, Washington Mutual, Fortis, Dexia and others) was clearly in question and rescue packages of one sort or another had to be put in place to protect their depositors. Under these circumstances a default by a €100 billion bank such as Anglo Irish Bank would undoubtedly have put funding pressure on the other main Irish banks via contagion, given the broad similarities in the type and geography of their property-related lending, their common implicit reliance on the backing of the Irish State, and even name confusion. In this sense, the systemic importance of Anglo Irish Bank at that time cannot seriously be disputed.

8.43 There can be little doubt that a disorderly failure of Anglo would, in the absence of any other protective action, have had a devastating effect on the remainder of the Irish banks. Given the other banks' reliance from day-to-day and week-to-week on the willingness of depositors and other lenders not to withdraw their funds, and the certainty that those lenders would infer from the failure of Anglo that all the other Irish banks might be in a comparable situation, in all likelihood the main banks would have run out of cash within days. They did not have unused collateral eligible for borrowing at the ECB's facilities in sufficient amounts to meet a run on the scale which would have ensued. Absent Government support or ELA they would have to close their doors also, unable to pay out on cheques presented and other payments instructions. Closure

of all, or a large part, of the banking system would have entailed a catastrophic immediate and sustained economy-wide disruption involving very significant, albeit extremely difficult to quantify, social costs, reflecting in particular the fundamental function of the payments system in a modern economy. These costs would have been broad-based in terms of income, employment and destruction of the value of economic assets and would have been on top of the recessionary downturn which has actually occurred. Considering the experience of other countries in such circumstances, the social and economic costs, if they could be quantified, would surely have run into tens of billions of euros.[161] There would also have been spillover effects *vis-a-vis* other countries. So either Anglo's disorderly bankruptcy had to be avoided, or protective measures taken for the rest of the system, or – as was decided – both[162].

8.44 These immediate costs were avoided by the guarantee. But was the likely deferred cost of a guarantee also perceived to be small? After all, there is a natural tendency, even for public servants, to avoid immediate crystallisation of problems even at the cost of larger likely subsequent costs. In this case, though, at the time the authorities did not believe that Anglo was heading towards insolvency. The potential for a major payout from the guarantee was not considered large, though no attempt was made at quantification. There were arguments against a blanket guarantee, including one made by the Department of Finance's advisors Merrill Lynch who observed that the assumption of such a large contingent liability would have an adverse effect on the borrowing costs for the State. And there is a moral hazard involved in any such

[161] The indirect costs of the failure of systemically important institutions, triggering a wider systemic collapse, are hard to evaluate. In most historic cases governments have stepped in to prevent disorderly bankruptcies, instead absorbing some of the failing banks' losses into the fiscal accounts but keeping the day-to-day operations of the banks going. Recent cases where this did not occur include Indonesia in 1998 and Argentina in 2001. These economies were already gripped in deep recession when their banks failed. The disorderly bank closures contributed to a deepening of the crisis, but to what extent nobody has been able to estimate with any precision. Of course a comparison with these economies needs to take account of the fact that they both operate with much smaller banking systems relative to their economy, and that most of their economic structure did not depend on unquestioned reliance on financial contracts. The case of Iceland is also relevant (see Box 8.5).

[162] With the benefit of hindsight, a plausible case can be made for a more complicated policy as perhaps offering a lower net cost in the end. Thus, the whole system *except Anglo* could have been guaranteed, allowing the latter to close, without that implying destruction of the rest of the system. Given what we now know about the extent to which most of the final fiscal costs of the guarantee come from Anglo, on the face of it such a course would have offered savings. It would not, however, have been trouble-free. It would have earned harsh criticism from other EU countries as being a ―second Lehmans" imposing a destabilising spill-over effect on them, would have caused a jump in government borrowing costs and would have entailed large and arbitrary costs to Anglo creditors, including other banks, resulting in economic disruption and job losses. Since the decision makers had no inkling of the scale of the looming net deficiency in Anglo, this option – with its sizeable risks in an already volatile environment – did not seem worth considering. As such, it is of academic interest only.

guarantee, though this argument does not appear to have been made. Still, given the perceived lack of a solvency problem at Anglo (or the other banks) on balance a guarantee seems to have been the best approach, not least because no other clear and effective medium-term solution appeared available. This is not to underestimate the huge cost to the bailout which has ended up in excess of 15 per cent of GDP.

Box 8.5: Contrasts between Ireland and Iceland

The country with the largest banking sector failures relative to the size of the economy in the current global financial crisis is Iceland. Little affected by the US subprime market problems, the Icelandic banking system was destroyed by a nationally-generated bubble.

Although it was also a locally-generated bubble that created the problems in the Irish banking system, the parallels between the two countries' experiences are not all that close, as is revealed by the Report of the Investigation Commission in Iceland.

For one thing, the expansion of the Icelandic banking system – where the three main banks expanded twenty-fold in seven years – an annual average rate of growth of over 50 per cent, far higher than even the growth rate of Ireland's fastest growing bank Anglo. Furthermore, the losses that have been incurred almost ten times those of Ireland when measured relative to each country's GDP. The average asset-write-down for the three Iceland banks is estimated at 62 per cent – far higher than the write-downs required even for the worst of the Irish banks in relation to their NAMA loans.

The pattern of bank behaviour in Iceland was also different. Property lending was not so central to the Iceland case. The SIC reported an extraordinary amount of self-lending by bank insiders; the largest exposures of Glitnir, Kaupthing Bank and Landsbanki were the banks' principal owners. While loans to Directors in one Irish bank have been the focus of attention, it was on a much smaller scale. The Icelandic banks took on a sizeable exposure to their own shares, and the shares of the other banks, especially during 2007; by mid-2008, own- and cross-exposure had reached the level of 70 per cent of core capital; in effect, the banks had collectively financed far too high a proportion of their owners' equity. (The CFD-related transaction in one Irish bank represented a much smaller fraction). Other features lacking in the Irish situation but important to Iceland were the growth in investment funds managed by the banks, and the extraordinary late expansion into retail franchises in other countries as the Iceland banks attempted to substitute wholesale funds with retail deposits.

Finally, in contrast to the Iceland authorities, the CBFSAI did increase capital requirements in an attempt to slow risky lending – albeit by too little.

8.45 If ELA had been used to maintain the system to the end of the week it could also have allowed the nationalisation of Anglo Irish Bank to be carried out without operational

risk. Given the true underlying situation of Anglo Irish Bank and INBS, namely that they were heading toward loan losses that would more than wipe out their capital, it could have turned out to have been quite risky to leave them under unchanged ownership.[163] Furthermore, a better loss-sharing arrangement with providers of capital might have been more easily negotiated had one or two banks been dealt with separately[164] from the system. Still, even given these considerations, it is hard to argue that the delay of five months in eventually nationalising Anglo Irish Bank had a major financial impact.

8.46 The **sudden introduction of the scheme** with hardly any notice to partner EU countries presented some issues, given the existence of a single EU banking market. The Irish subsidiaries of foreign banks were only included subsequently (on 9 October) following representations. The guarantee created market and political pressure for the introduction of similar schemes across Europe and some dissatisfaction was expressed at high political level with the Irish action. In the event, in the following ten days, six other countries[165] introduced blanket deposit guarantees – though none of them were as extensive as the Irish scheme. While this is conjectural more prior consultation on alternative options might have alleviated the pressures on Ireland without creating the tensions prompted by a sudden unilateral action. After all, an EU-wide response to the crisis did eventually emerge in the following week. It is possible that recourse to ELA might have bought some time for such eventualities.

Section 5: Conclusions

8.47 There is no doubt that from mid 2007 onwards Ireland increasingly faced a potentially serious financial crisis. Although the deteriorating international environment was what finally set the flames alight elements had been building for some considerable time beforehand. The overly sanguine, even complacent, view presented in the 2007 FSR and the resulting ensuing conviction that whatever problems that might arise would only be one of a liquidity led to two missed opportunities; first, to convey a strong message

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[163] The looting of insolvent banks by management is extensively documented in the historical literature concerning similar events in other countries. However, there is no reason to believe that this occurred in either Anglo or INBS. Any such risks that may have been considered to exist were mitigated by intensified supervision and the appointment of two Directors on each Board by the Government.

[164] Some of Anglo Irish Bank's subordinated debt was bought back by the bank at well below par, although the net present value of the savings from these transactions have not been examined for this report.

[165] Austria, Belgium, Denmark, Germany, Slovak Republic and Slovenia. Other EU countries also increased the ceiling on their existing deposit insurance schemes during this period.

to the banks that they needed to build up capital urgently to be able to handle contingencies, or even to require them to do so; and second, to undertake comprehensive preparatory work to analyse quantitatively policy options available in the event the unthinkable might transpire.

8.48 Although it was not underpinned by specific analysis, the decision early on not to countenance the ―failure” of any bank simplified subsequent decisions. This decision was not initiated by the CBFSAI, but was consistent with its view. However, it was an oversimplification which short-circuited decisions that deserved closer scrutiny. Under the circumstances of the extraordinary international financial market environment of those weeks, it was an understandable position. But it could not be a permanent policy if severe moral hazard was to be avoided. And it was also conducive to downplaying the importance of developing an appropriate legal framework for a special bank resolution regime scheme.

8.49 The ―no failure” policy also took the question of optimal loss-sharing off the table. In contrast to most of the interventions by other countries, in which more or less complicated risk-sharing mechanisms of one sort or another were introduced, the blanket cover offered by the Irish guarantee pre-judged that all losses in any bank becoming insolvent during the guarantee period – beyond those absorbed by some of the providers of capital – would fall on the State.[166] Given the ―no failure” policy, a guarantee with its costs were inevitable.

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

8.51 In addition to influencing financial stability policy, a key role of the Central Bank in a crisis is to ensure adequate provision of liquidity. It was prepared on the night of 29/30

[166] Cynical critics might suggest that the introduction of the guarantee immediately following the steepest one-day share price fall for an Irish bank might have reflected an attempt to protect even the shareholders. However, the evidence provided suggests that this was not a concern of policymakers.

September to extend a modest amount of ELA, but not enough to ensure that Anglo would get through the week. Thus back-up liquidity provision was instead hastily secured from the two largest commercial banks, and, crucially, backed by Government guarantee. In effect, the commercial banks were stepping in to provide the lender of last resort facility – which of course was in their own interest to do. The reluctance to deploy more significant ELA facilities from the Central Bank is open to question: such facilities were being used elsewhere and too much was likely made of the reputational risks involved (especially given that the guarantee was about to be announced). It is unlikely that even extensive use of the facility to buy time to facilitate nationalisation the following weekend would have been viewed negatively by partner central banks under the circumstances. While use of ELA would only have been a temporary solution, it might have bought some breathing space while other possibilities were being explored to address the unprecedented situation that many – not only in Ireland – were facing.

8.52 The decision not to proceed with nationalisation of Anglo Irish Bank on 29/30 September has become the subject of considerable public debate and controversy. Two questions are raised. First, should policy makers have had a greater sense that Anglo was facing not only a liquidity, but also a potential solvency problem? The answer is probably yes. Second, would nationalisation of Anglo on 30 September – compared with its nationalisation five months later – have made a significant difference to the overall cost of the bank bail out to the taxpayer? Here the answer is ―probably not".

8.53 Finally, there has been some criticism, including from abroad, as regards the hurried nature of the decision and in particular, the lack of prior consultation with partners. This criticism may have some basis, especially since, as argued above, there was scope for more thorough exploration of options – including *vis-a-vis* European partners – in the period leading up to 29 September. At the same time, given the position the authorities found themselves in on that night it is understandable why, given the extreme time pressures, all efforts were devoted to finding an immediate way to save the Irish banking system from looming disaster.

ANNEX 2: MEMORANDUM OF UNDERSTANDING ON FINANCIAL STABILITY BETWEEN THE GOVERNOR AND BOARD OF THE CENTRAL BANK AND FINANCIAL SERVICES AUTHORITY OF IRELAND AND THE IRISH FINANCIAL SERVICES REGULATORY AUTHORITY

1. This Memorandum of Understanding (MoU) sets out principles for cooperation between the Governor and Board of the CBFSAI (hereinafter referred to as ―the Bank") and IFSRA (hereinafter referred to as ―the Financial Services Regulator") in the field of financial stability. It sets out the role of each party and explains how they will work together towards the common objective of financial stability.

2. Financial stability is a situation where the components of the financial system (financial markets, payments and settlements systems and financial institutions) function smoothly and without interruption, with each component resilient to shock. A financial stability matter may include, but would not be restricted to, any event which could threaten the stability of an important financial institution or number of institutions; disrupt the workings of financial markets and/or the payment system, or undermine the soundness of, or public confidence in, the financial system.

3. Three guiding principles will govern cooperation between the parties:
   i) ***clear accountability and transparency:*** each party will be accountable for its actions as set out in this MoU;
   ii) ***no duplication:*** each party will ensure that duplication does not occur, as far as is reasonably possible; and
   iii) ***data and information exchange:*** both parties will ensure that the content and frequency of exchange of data and information will enable each party to discharge its responsibilities as efficiently and effectively as possible.

4. **The Bank's Responsibilities for Financial Stability**

   The Bank is responsible for contributing to the overall stability of the Irish financial system. This mandate for financial stability is derived from:
   i) the Bank's statutory duty under the CBFSAI Act of 2003. The Act specifies that ―the Bank has … the objective of contributing to the stability of the financial system"; and
   ii) the mandate of the European System of Central Banks, which requires the European Central Bank and National Central Banks to contribute

to financial stability in the euro area. This, therefore, requires that the Bank contribute to financial stability, both in Ireland and, as far as is practicable, elsewhere, through its involvement in international fora.

To carry out the Bank's mandates for financial stability, the Governor and the Board's responsibilities therefore involve:

i) ***stability of the monetary system***. This will be monitored as part of the ESCB monetary policy function. As necessary, actions will be taken in the markets and fluctuations in liquidity dealt with;

ii) ***financial system infrastructure, in particular the payments and securities settlements system***. The Governor and/or Board will advise the Minister and Financial Services Regulator on any significant matter affecting these systems. The Governor and/or Board will continue to promote the smooth operation of the payments and securities settlement systems and will also seek to strengthen these systems to reduce systemic risk;

iii) ***overview of the domestic financial system as a whole***. The Governor and/or Board will advise all relevant parties on the implications for financial stability of developments in domestic and international markets and payments systems and assess the impact on monetary conditions of events in the financial sector;

iv) ***analysis of the micro-prudential – where appropriate – as well as macro-prudential health of the financial sector***. In this context, the Governor and/or Board's objective is to identify developments which could endanger the stability of the system as a whole and will advise accordingly;

v) ***undertaking official financial operations***. The Governor and/or Board may authorise official financial operations in exceptional circumstances, in order to limit the risk of difficulties affecting particular institutions spreading to other parts of the financial system; and

vi) in addition to the above mainly domestic responsibilities, they ***contribute to promoting improvements in the international financial system,*** mainly through involvement in international fora.

5. The Financial Services Regulator's Role in contributing to Financial Stability

The Financial Services Regulator is responsible for contributing to the maintenance of proper and orderly functioning institutions and exchanges and protecting depositors, insurance policy holders and clients of investment firms. In carrying out these

functions, the Financial Services Regulator will support the Bank‘s objective of contributing to financial stability.

The Financial Services Regulator‘s responsibilities in this area therefore include:

i) the ***prudential supervision*** of banks, building societies, insurance companies, stockbrokers, exchanges, investment firms, retail intermediaries (both investment and insurance intermediaries), credit unions and collective investment schemes (managed funds); and

ii) providing ***advice, information and assistance*** in relation to the Bank‘s functions to the Bank‘s Board and the Governor, both on request and at other times as may seem appropriate.

6. Data and Information Exchange

There will be close and regular contact between the parties and a framework of cooperation will be developed with regard to financial stability matters. Information sharing arrangements will be established, to ensure that all information relevant to the discharge of their respective responsibilities will be shared fully and freely between the parties. Each party will seek to provide the other with any additional information on request and as appropriate.

7. Crisis Management

The parties will immediately inform and consult with each other in relation to any matter which either party deems to have the potential to threaten the stability of the financial system. The general procedures to follow in such an event will continue to be for agreement between the parties.

8. Consultation on Policy Changes affecting Financial Stability Matters

The parties will consult and inform each other about any policy changes which will have a bearing on the responsibilities of the other.

9. Financial Stability and Membership of Committees

The parties will cooperate fully in their relations with and participation in international fora on financial stability issues. In some cases, this will involve dual representation in certain fora. In cases where only one party is represented, the other undertakes to contribute information and advice in advance of any meeting. The party attending will fully brief the other after the meeting.

10. Records

The Financial Services Regulator will be responsible for the custody of all records relating to the prudential supervision of authorised institutions. The Governor and Board of the Bank will have free and open access to these records on matters relating to financial stability.

The findings of the Honohan, Regling and Watson and Nyberg reports into the financial crisis and material on some of the measures that have been put in place to address the shortcomings identified in these reports.

1. Introduction

Category 10 of the Direction from the Joint Committee seeks the following:

> Document detailing all changes implemented by the Department of Finance from the recommendations of the Irish Banking Crisis, Regulatory and Stability Policy 2003 to 2008 by Patrick Honohan, Governor of the Central Bank, Misjudging Risk: Causes of the systemic banking crisis in Ireland by Peter Nyberg, sole member of the Commission of Investigation (Banking Inquiry), A Preliminary Report on the Sources of Ireland's Banking Crisis by Max Watson and Klaus Regling and Review of the Department of Finance by Rob Wright for the period 2008 to 2010. [Ref.ID r6a]

As there is no document on record specifically addressing this point as raised, this document has been created for the purposes of assisting the Joint Committee with this item.

The Joint Committee request specifically relates to the implementation of *recommendations*. Please note that:

- Irish Banking Crisis, Regulatory and Stability Policy 2003 to 2008 by Patrick Honohan, Governor of the Central Bank did not make recommendations, but drew conclusions.

- Misjudging Risk: Causes of the systemic banking crisis in Ireland by Peter Nyberg made findings, drew some conclusions and identified lessons to be learned

- A Preliminary Report on the Sources of Ireland's Banking Crisis by Max Watson and Klaus Regling identified policy lessons to be learned and recommended areas for further investigation.

Therefore, while the reforms to the Irish regulatory system introduced in recent years were heavily informed by the work undertaken in these reports, the reforms did not involve implementing recommendations per se.

A summary of the key points highlighted in the reports is attached at Appendix I. The points cover fiscal, staffing and regulatory issues. The first two are covered in Direction Number 10 relating to the Wright Report.

2. Material for inclusion in the Department report on measures that have been put in place to address the shortcomings highlighted in these Reports

Acting on the recommendations contained in those reports, a number of significant reforms have been undertaken towards building a strengthened regulatory framework for the financial services sector and to respond to the shortcomings identified in those reports.

It should be noted that a number of findings in the reports relate to the need for improved internal structures, skill sets and resources within the Central Bank. A considerable amount of work has been done by the Central Bank across these fronts, with details set out in the documents: Banking Supervision: Our New Approach, the 2011 update, Enforcement Strategy.

Addressing the institutional separation between the regulator and the central bank
The Central Bank Reform Act 2010 abolished IFSRA and created a single fully-integrated Central Bank of Ireland with a unitary board – the Central Bank Commission – chaired by the Governor of the Central Bank. The unitary Central Bank structure gives the Commission members a more complete remit over prudential regulation and financial stability issues. The 2010 Act specifically provides that the Commission shall ensure that the Bank's central banking functions and financial regulation functions are integrated and coordinated. The Act further provides that one of the objectives of the Central Bank is the stability of the financial system overall.

An improved emphasis on regulatory performance
The 2010 Act enhanced accountability and oversight mechanisms through a number of measures including:

- A specific focus by the Commission on regulatory performance
- Annual Performance Statements on regulatory performance prepared by the Bank, presented to the Minister for Finance and laid before the Houses of the Oireachtas.
- A Strategy Statement which is to be prepared at least every three years
- International peer reviews of regulatory performance prepared every four years with the report of same forming part of the Performance Statement in the relevant year.
- A committee of the Oireachtas may call the Governor and/or the Deputy Governors to be examined on the Performance Statement.

A more assertive supervisory approach
The Central Bank (Supervision and Enforcement) Act 2013 overhauls the Central Banks powers across a wide range of areas and throughout the regulatory life cycle of firms.

The Central Bank acquired extensive powers to make regulations including in relation to areas identified as weak points in the post crisis analysis such as risk management, consumer protection, audit processes and lending, including lending to 'restricted persons' such as those who work within the bank or family members.

The Central Bank acquired extensive new information gathering and authorised officer investigation powers, pulling together disparate and inconsistent statutes into one clear and focussed set of powers. Crucially these powers are available to allow the Central Bank to go beyond the regulated entity into related undertakings so that they can get a full picture of the wider family of companies to which a regulated entity belongs. This combats attempts by firms to circumvent regulation using labyrinthine company structures.

The Central Bank was also given the powers to require the *creation* of information, including analysis, stress tests and forecasts. To overcome concerns about receiving biased or imbalanced information, the Central Bank now has the power to require a firm to hire an independent third party (approved by the Central Bank) to carry out objective analysis – the cost of this is borne by the regulated entity. The Act also provides a new mechanism – based

on company law – to deal with claims of legal privilege and to ensure that documents cannot be withheld on the basis of spurious claims of privilege.

Combatting wrongdoing: auditors and whistleblowers

The 2013 act provides comprehensive protections for whistleblowers to ensure that those who report suspected wrongdoing do not get penalised for it. Specifically the act places an obligation on those performing key functions in the industry (pre-approval controlled functions) to report wrongdoing to the Central Bank.

In line with the Nyberg recommendations, the Act provides a limitation of liability to allow auditors to have more open discussions with the Central bank without being limited by confidentiality restrictions. In addition the Act provides for a new auditor assurance provisions, which provides for auditors to examine the extent of a firm's compliance with certain identified regulatory requirements.

Early intervention powers for the Central Bank

The 2013 Act sets out a the power of the Central Bank to issue directions to regulated entities and their related undertakings to address emerging problems, including where the entity has become or is likely to become unable to meet its obligations to its creditors or its customers, or where is not maintaining or is unlikely to be in a position to maintain adequate capital or other financial resources. In other words, the Central Bank does not have to wait until a firm has committed a contravention before acting, it can intervene where there are emerging risks that need to be headed off.

A direction, which is enforceable in the High Court, can require capital raising, the suspension of business and modification to systems and controls, among other things.

The Act also provides that if, in the opinion of the Bank, a person has engaged, is engaging or is about to engage in a contravention the Bank may apply to the Court for an order restraining the person from engaging in the conduct. This further reinforces the ability of the Central Bank to act on emerging problems in a timely way.

Stronger enforcement powers 'carrying a big stick'

Since the commencement of the Central Bank (Supervision and Enforcement) Act 2013, the Central Bank may impose a monetary penalty upon a body corporate or an unincorporated body of the greater of €10,000,000 or an amount equal to 10 per cent of the turnover of a firm. In relation to breaches that arose prior to the commencement of the 2013 Act, the maximum penalty that the Central Bank could impose on a firm was €5,000,000. The 2013 Act also allowed for the doubling of the maximum administrative sanction to €1,000,000 for a natural person.

The Central Bank's Strategic Plan 2013 - 2015 sets out a strategy of assertive risk-based supervision underpinned by a credible threat of enforcement. Enforcement is an important tool to effect deterrence, achieve compliance and promote positive behaviour. The Central Bank will take enforcement action against regulated entities under its Probability Risk and Impact SysteM (PRISM) supervisory model.

The reports referred to above, note the lack of enforcement action by the Central Bank in the pre-crisis era. The following table is a list of all fines greater than €100,000 imposed by the Central Bank by way of settlement agreement on financial institutions over the past six years.

Institution	Date	Fine
Quinn Insurance Limited ("QIL") and Mr Sean Quinn Senior	24/10/2008	€3,450,000
Irish Life & Permanent plc	03/09/2009	€600,000
Merrill Lynch International Bank Limited	22/10/2009	€2,750,000
DEPFA ACS BANK	16/12/2009	€250,000
NCB Stockbrokers Limited	16/12/2010	€100,000
Allied Irish Banks plc	17/12/2010	€2,000,000
Scotiabank (Ireland) Limited	02/06/2011	€600,000
MBNA Europe Bank Limited	21/06/2011	€750,000
Goldman Sachs Bank (Europe) plc	08/09/2011	€160,000
Combined Insurance Company of Europe Limited	16/12/2011	€3,350,000
Aviva Life & Pensions Ireland Limited	07/03/2012	€245,000
Aviva Health Insurance Ireland Limited	09/03/2012	€245,000
Alico Life International Limited	29/03/2012	€3,200,000
Bank of Ireland Mortgage Bank	02/10/2012	€120,000
Ulster Bank Ireland Limited	14/11/2012	€1,960,000
Aviva Insurance Europe SE	17/12/2012	€1,225,000
Aviva Life & Pensions Ireland Limited	17/12/2012	€1,225,000
Quinn Insurance Ltd	18/02/2013	€5,000,000
Citibank Europe plc	11/12/2013	€550,000
Allied Irish Banks plc	17/12/2013	€490,000
Ava Capital Markets Limited	04/03/2014	€165,000
UniCredit Bank Ireland p.l.c.	13/03/2014	€315,000
FBD Insurance plc	08/05/2014	€490,000
Squared Financial Services Limited	16/05/2014	€100,000
Bank of Montreal Ireland plc	21/05/2014	€650,000
Ulster Bank Ireland Limited	06/11/2014	€3,500,000

Effective follow-up action
The 2013 Act introduced a number of provisions to allow the Central Bank to follow-up on serious problems. This includes new customer redress powers to address problems that are widespread or regular and which result in losses to consumers, such as mis-selling or overcharging. A further change means that where customers suffer loss through a breach of financial services legislation, they may bring an action for damages. A new restitution provision provides a Court process to deal with situations where a person has been unjustly enriched or others have suffered losses arising from a prescribed contravention.

Crisis readiness and early intervention to tackle firm failure
The Central Bank and Credit Institutions Resolution Act 2011 provides a comprehensive basis for the Central Bank to prepare for firm failure and intervene decisively to prevent wider stability problems arising from firm failure. The Act provides for recovery and resolution plan; directed transfer; special management; bridge banks; and liquidation; as well

as a Resolution Fund to provide funding for these actions. The introduction of BRRD and SRM will supersede much of this Act, which has nevertheless been used on a number of occasions to address problems with credit unions since its enactment.

Addressing cultural change in banking

In 2011 the new Fitness and Probity regime was rolled out by the Central Bank in accordance with the provisions of the Central Bank Reform Act 2010. The regime provides for new powers to be exercised by the Central Bank to ensure the fitness and probity of nominees to key positions within financial service providers and of key office-holders within those providers.

On the basis of the Central Bank Reform Act 2010, the Bank has put in place a pre-approval process for persons who apply for relevant positions (called Pre-Approval Controlled Functions or PCFs) in regulated firms, to ensure that they meet the required standards of fitness and probity. If concerns arise that a person or persons in Controlled Functions in a regulated firm do not meet the required standards of fitness and probity, they may be investigated by the Central Bank and could ultimately be prohibited from carrying out a Controlled Function in their firm, or any other regulated firm. These powers equip the Bank to ensure that the people in senior roles are capable, competent and act with integrity.

SSM

The introduction of the SSM is a fundamental change as to how banking supervision is conducted. The SSM comprises of the ECB and the national competent authorities (NCAs) of participating Member States. From 4th of November 2014, SSM is responsible for the prudential supervision of all credit institutions in the participating Member States, which includes Ireland.

For Significant Institutions supervision will be aligned with the SSM Joint Supervisory Team structure which will be led by the ECB. The JST will comprise staff from both the ECB and NCAs. The JSTs will be responsible for prudential supervision. For Less Significant Institutions, supervisory responsibility will remain with the Central Bank. Supervision will be conducted in accordance with European law and EBA standards but also in line with the harmonised standards and processes that the SSM has developed.

The SSM approach to supervision is risk-based. It takes into account both the degree of damage which the failure of an institution could cause to financial stability and the likelihood of such a failure occurring. Where the SSM judges that there are increased risks to a credit institution or group of credit institutions, those credit institutions will be supervised more intensively until the relevant risks decrease to an adequate level. The SSM approach to supervision is based on qualitative and quantitative approaches and involves judgement and forward-looking critical assessment.

In carrying out its prudential tasks, as defined in the SSM Regulation, the ECB applies all relevant EU laws and, while the NCAs apply national law. The ECB is subject to technical standards developed by the European Banking Authority (EBA) and adopted by the European Commission, and also to the EBA's European Supervisory Handbook.

Credit Register
The Regling and Watson report specifically identified the need for a credit register.

The Credit Reporting Act, 2013 took effect from the January 2014. The legislation provides for the establishment, maintenance and operation of a Central Credit Register by the Central Bank of Ireland.

When the Register is operational it will act as a support to the financial services industry in order to underpin and promote responsible lending and responsible borrowing. It will also aid the supervisory functions of the Central Bank and will enhance consumer protection measures in respect of lending.

The Register will contain credit information pertaining to both consumers and businesses. The Act also provides that credit providers must access the Register when a consumer or business makes an application for a loan in excess of €2,000, in order to ascertain their creditworthiness. Benefits for consumers will include free access to their own credit record once every twelve months. There will be an audit trail on each record, controls on access, data protection requirements as well as measures to mitigate the opportunities for identity theft.

Enactment of the legislation and the introduction of the new credit register will help to support the Irish banking system. Placing a mandatory reporting requirement on credit information providers will help to ensure that the credit register contains robust data.

Appendix I

Honohan Report

As regards the CBFSAI, the Honohan Report identified the following threefold root problems:

- a regulatory approach which was and was perceived to be excessively deferential and accommodating; insufficiently challenging and not persistent enough. This meant not moving decisively and effectively enough against banks with governance issues. It also meant that corrective regulatory intervention for the system as a whole was delayed and timid. This was in an environment which placed undue emphasis on fears of upsetting the competitive position of domestic banks and on encouraging the Irish financial services industry even at the expense of prudential considerations.

- an under-resourced approach to bank supervision that, by relying on good governance and risk-management procedures, neglected quantitative assessment and the need to ensure sufficient capital to absorb the growing property-related risks.

- an unwillingness by the CBFSAI to take on board sufficiently the real risk of a looming problem and act with sufficient decision and force to head it off in time. ―Rocking the boat and swimming against the tide of public opinion would have required a particularly strong sense of the independent role of a central bank in being prepared to ―spoil the party and withstand possible strong adverse public reaction.

The Report identified many other factors which, it concludes, may have militated against the effectiveness of the CBFSAI during this period; however, the report notes that that these factors may have contributed to the crisis but were not fundamental:

- quantity and skill mix of the staffing of the bank regulation function;
- an unduly hierarchical CBFSAI culture discouraging challenge;
- management process problems;
- difficulties, related to the rather unwieldy organisational structure, in ensuring coordination between economist and regulator sides of the house; and
- weaknesses in preparing for a crisis.

The Report also drew a number of key conclusions about regulatory performance:

- The style of supervision adopted did not generate the most relevant or useful information to anything near the extent required (para 1.9)
- The institutional separation of the regulator from the rest of the central bank led to an insufficient appreciation of the micro-macro linkages involved in financial stability analysis (para 1.19)
- Though few would now defend the institutional structure invented for the organisation in 2003, it would be hard to show that its complexity materially contributed to the major failures that occurred (para 3.23)

- While consistent with the espoused regulatory philosophy, the reluctance to take decisive action can also be characterised as displaying both deference and diffidence to the regulated entities (para 4.50)
- Only a small number of persons was allocated to supervise leading credit institutions. Given the considerable asymmetry in expertise and seniority between the staff of the FR and the regulated institutions, this is likely to have hampered effective supervision.(para 5.31)
- The Financial Regulator‘s appetite for legal risk was very limited; this meant in practice that the regulated entities got the benefit of the doubt – at least with regard to prudential issues; no Administrative Sanctions were ever imposed before 2008 on a credit institution in relation to a prudential matter. It also reduced the chance of obtaining through legislation any further powers necessary given that doubt about the adequacy of legal powers was not tested in court (para 5.32)
- The process-based regulatory model the FR inspectors were adhering to was not designed to provide a quantitative or graduated indication of the magnitude of the risks to solvency and the likelihood that they would materialise. Thus the weakest bank was given a relatively favourable assessment until close to the edge of the cliff, thereby helping to shape the incorrect assessment by many key policy makers at the time that the liquidity problems the bank was experiencing in late 2008 reflected worldwide market failures and not an underlying lack of solvency (para 5.33)
- The CBFSAI‘s Financial Stability Reports throughout this period were broadly similar in approach to those undertaken by central banks elsewhere . . . the key message was that these risks to the extent it was believed that they might materialise were manageable and not a major cause for concern (para 6.38).

Regling and Watson Report

Chapter IV of this report set out the over-arching lessons from the experience in Ireland under seven broad categories:

- In euro area members, fiscal and prudential policies must take into account, and seek to mitigate, a mismatch between monetary conditions and the national business cycle. This can be especially important during the period of transition to euro area membership, as the economy adjusts under the euro to a new steady state.

- The management and surveillance of euro area economies must take fully into account the imbalances and risks that can build up in both the private and the public sector of national economies, including “external” imbalances vis-a-vis other euro area members, and the way those imbalances are funded. So long as fiscal and labour market policies remain national to an important extent, the national balance of payments is a meaningful economic concept even within the euro area.

- The design of fiscal policy needs to build in sufficient allowance for temporary revenues, and the tax base should not be eroded (especially for distortive goals). The introduction of independent institutional sources for economic and fiscal projections would appear useful. It may also be helpful, after the immediate phase of crisis management, to explore the use of a domestic fiscal rule, such as a medium-term expenditure ceiling, to supplement the EU Stability and Growth Pact.

- In an adaptive financial system, there is a case for principles-based supervision, in conjunction with clear rules. But the "light-touch" approach to supervision has been discredited: it sent wrong signals to banks and left supervisors poorly informed about banks' management and governance, potentially impairing crisis response capacity also.

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

- Financial stability analysis must be more strongly integrated into supervision. It needs to capture liquidity as well as solvency risks, and it must explore in a more contrarian way various macrofinancial scenarios for the economy, including economic correlations among assets, and between assets and liabilities, of the kind referred to above. There is need for a more interactive, and at times a more confrontational culture, in the inter-agency discussions that explore risks during fiscal and supervisory policy design.

- Supervisory co-ordination in the EU needs to become much more intense and operational; and it needs to address cross-border risks of a macroprudential kind, not just a microprudential kind that emerge in national markets.

Nyberg Report

The Nyberg report identifies a number of important lessons (page ix):

- A main lesson is the need to make sure, both in private and public institutions, that there exist both fora and incentives for leadership and staff to openly discuss and challenge strategies and their implementation.

- In part because they must form a view on banks' financial sustainability, bank auditors should have a regular, compulsory dialogue with its client's senior management and boards on the bank's business model, strategy and implementation risks. The result of such discussions should also, at least when clearly relevant, be communicated to the FR.

- It seems unlikely that regulatory or governance reform alone will prevent a future crisis. This argues for structural changes in the banking sector, appropriately reducing and delimiting at least the part of the banking system that may be subject to the various types of government support.

- It is the impression of the Commission that long, preferably practical, experience in financial markets has a tendency to promote not only competence but also financial prudence. Banks might do well, in the long run, to ensure that their senior management has, or at least has close access to, extensive lending and risk management expertise; more banking experience in boards would also prove useful.

Authorities might also do well to make even greater use of experienced practitioners, domestic and foreign, in various roles.

- Cooperation between all relevant authorities needs to become less formal but more comprehensive and should include professional staff. While accountability requires clarity on who makes a decision, the need for good decisions would seem to require regular, open, professional and constructive discussion among all relevant institutions. In that regard, much remains to be done in Ireland and elsewhere. For instance, it seems particularly vital to urgently and substantially increase staff with financial market expertise in the DoF for it to be able to actively fulfil its part of the stability mandate, including cooperating closely and professionally with the CB and internationally.

- Finally, it appears to the Commission that little seems to argue against policies to markedly limit (even properly structured) bonus and pay for management in both banks and authorities, in Ireland and internationally.

The Nyberg report also made a number of findings in respect of the Authorities (pages 88-93):

The Financial Regulator

- Even when problems were identified and remarked upon, the FR did not subsequently ensure that sufficient corrective action was taken. Thus, even insightful and critical investigation reports tended to have little impact on banking practices.

- Allowing INBS to continue operations without major reforms or sanctions must, on the part of the FR, have reflected either a reluctance to pursue legal action or a profound trust in bank management and the board.

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

The Central Bank

- The Financial Stability Report (FSR) was constrained to present benign conclusions with a number of almost routine warnings voiced in the text itself. Simultaneously, macro-economic data signalling the emergence of the two key risks – growing dependence on foreign funding and the concentration of bank lending in the property sector – did not appear to have caused acute concern.

- There are signs that a hierarchical culture, with elements of self-censorship at various levels, developed in the CB. This eventually made it even harder to address the increasing instabilities in the financial market.

- The Nyberg Commission is aware of but disagrees with the view that the CB would not have been entitled to intervene to address stability issues concerning individual banks.

The Department of Finance

- The Department of Finance (DoF) did not, despite its mandate, see itself as concretely involved in financial stability issues; it also did not have the requisite professional staff for this.

- The DoF saw itself as preparing legislation to be implemented by the other authorities, but appears to have avoided addressing other financial market issues unless brought to the table by the FR or the CB (for instance, Credit Union issues during the Period). This apparently was due to their legally independent status. The Commission could find no evidence that the DoF formally tried to influence the FR in its work.

- The DoF also did not make any efforts to strengthen its own financial market expertise despite crisis management exercises in the EU having shown a need for it among finance ministries.

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

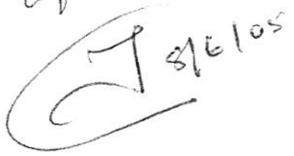
F 009/040/08

Information Note on Directors' Compliance Statement

1. William Beausang ✓
2. Secretary-General ✓
3. Rúnai Aire

Minister, I undertook to prepare an information note on this for you

Note submitted, as requested



Billy Hawkes
BFID
7 June 2005

Seen by Minister

B Rafter 28/6/05

Recd KC. 2/4/08

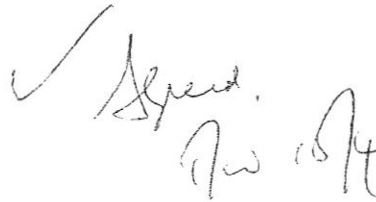
Minister, for information

RE: Obligation on financial services providers to provide compliance statements.

Section 26 of the CBFSAI Act 2004 includes a provision for the Financial Regulator to require Compliance Statements from regulated financial service providers. In response to an informal consultation process industry and other interested parties have raised serious concerns with the Financial Regulators proposal that section 26 should be implemented through themed reviews and in follow up to investigations.

Having considered the industry response the Financial Regulator has proposed that the Compliance Statement provisions introduced by section 26 of the 2004 Act should be reviewed as part of project for the consolidation and modernisation of financial services legislation. They also proposed that they would not exercise the powers provided by section 26 pending the outcome of the review.

The Department has indicated to the Financial Regulator that it would be agreeable to review section 26 as part of the consolidation and modernisation project and has accepted that the powers will not be exercised by the Regulator in the interim.



Kevin Cardiff

11 April '07

Directors Compliance Statement

Company Law Requirement (not yet in force)

Section 45 of the Companies (Auditing and Accounting) Act 2003 - which has not yet been commenced - imposes an obligation on company directors to report annually to shareholders on the company's compliance with company law, tax law and on other enactments that materially affect the company's financial statements. It applies to public companies (plcs) and to large private companies whose balance sheet total and turnover exceed specified amounts.

The measure arose from the PAC's DIRT enquiry and the fact that a number of directors of financial institutions pleaded ignorance of what was going on as a mitigating circumstance. The 2000 Report of the *Review Group on Auditing* (chaired by Senator Joe O'Toole) recommended that company directors be obliged to 'sign off' annually on their company's compliance with their legal obligations, and that the 'sign-off' be verified by the company's auditors. The 2003 Companies Act gave effect to this recommendation (but in a less demanding form than recommended by the Group).

Opposition to Measure

There has been growing opposition to the measure – especially from the international financial sector. Points made against it include:

- It would impose an unreasonable burden on company directors who would consequently be less willing to serve as directors
- It would impose an unreasonable cost burden on companies as they took measures to demonstrate full compliance to their Boards of Directors
- Other measures taken in recent years – notably enforcement action by the newly-established Director of Corporate Enforcement and by the Companies Registration Office – meant that compliance by companies with their legal obligations was now much better
- The requirement would put Ireland at a competitive disadvantage to other jurisdictions and was already being cited against us by our competitors

Referral to Company Law Review Group (CLRG)

On 20 April, the Taoiseach, and separately ETE Minister of State Michael Ahern, announced that the issue of the "proportionality, efficacy and appropriateness" of the compliance statement was being referred to the statutory CLRG. The Group has been asked to conduct a Regulatory Impact Analysis and to report back by 31 July.

Central Bank Act Requirement (in force but not yet applied)

Section 26 of the Central Bank and Financial Services Authority of Ireland (CBFSAI) Act 2004 provides that the Financial Regulator ***may*** require ***any*** regulated financial institution (not just companies) to provide a statement of its compliance with specified statutory and regulatory requirements (including codes etc issued by the Regulator) and to have the statement 'signed off' by the institution's auditors.

The Regulator has stated publicly that it will consult on how it will use these new powers. We understand that the timetable for such consultation has been put back due to the non-commencement of the company law compliance requirement

7 June 2005

DÁIL QUESTION

NO 110

To ask the Minister for Finance when the new common framework for testing the fitness of directors and senior managers of financial services published by the Financial Regulator, will come into effect; his views on whether existing directors and managers will not be subject to this test; if there are immediate plans to extend this framework to moneylending and mortgage intermediaries; and if he will make a statement on the matter.

- Róisín Shortall. (Nominated by: Joan Burton).

For ORAL answer on Wednesday, 22nd November, 2006.
Ref No: 39234/06

REPLY

Minister for Finance (Mr Cowen) :

My Department has been advised by the Financial Regulator that the new common framework for testing the fitness and probity of directors and senior managers of financial services firms will apply from 1 January 2007. Previously, the Financial Regulator assessed the fitness and probity of directors and managers against broadly similar standards but with different sectoral processes. Existing directors or managers will not have to complete the new Individual Questionnaire since they have already been subject to the previous sector-specific tests, but will be subject to the test for any new positions.

The Financial Regulator has also advised that moneylenders and mortgage intermediaries are already subject to regular fitness and probity tests as part of their authorisation procedure and because the existing test takes account of the specificities of the sector they work in it is not planned to extend the new common framework to them.

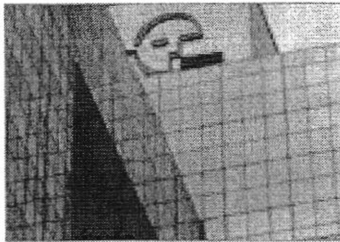
Directors and managers of financial service firms have an important role to play in ensuring that their firms treat their customers fairly and are run in compliance with applicable financial services legislation. The new common fit and proper requirements help prove that this role is discharged by persons who are competent and of good standing.

Ref No: 39234/06

Karen,
This PQ was before it was decided to defer consideration of compliance statement and is the only PQ we have on the issue - AC

IAS 39

Banks seek deferral on endorsement of standards on financial instruments



The Irish Bankers' Federation, to which FIBI is affiliated, is engaged in intensive dialogue with the International Accounting Standards Board (IASB) and the European Commission to resolve the issues regarding the controversial standard on financial instruments, IAS 39. This standard remains unendorsed, leading to an unacceptable level of uncertainty given that the implementation date for IFRS for all listed EU companies is 1 January 2005.

We remain of the view that the standard is fundamentally flawed. As it stands, it would lead to a situation where organisations' financial statements would fail to reflect the reality of underlying banking business. Business behaviors would be dictated by accounting rules. Our objective has consistently been to more closely align the requirements of the IAS 39 standard with current risk management techniques.

Cathrine Burke, Head of Accounting & Taxation

Keith Gross, Research Analyst

Irish banks, alongside their counterparts worldwide, object to IAS 39 as they believe this standard would result in increased volatility in financial statements, partly because of its proposed new provisions on hedge accounting.

The Irish banking industry remains fully committed to the IFRS programme and to financial reporting harmonization. Significant resources have been committed both to implementation programmes and to the dialogue with the IASB to resolve the issues. While the discussions on the standard have at times become highly technical, at its simplest the debate has hinged on the issue of hedging. Some progress has been made on hedging proposals that could form the basis of a future standard, but these discussions will not yield a solution by the 2005 deadline. At its June meeting, the EU Accounting Regulatory Committee (ARC), failed to take a formal vote on the standard. At the most recent meeting on 8 September, the Commission put forward three potential solutions designed to break the deadlock.

Option 1: The 'Carve Out' Option
Endorsing IAS 39 with the exception of the full fair value option and a limited number of provisions related to hedge accounting (macro-hedging).

Option 2: Temporary deferral for the Banking Industry
Endorsing IAS 39 with a sectoral carve-out for banks (until the hedge accounting issues are resolved).

Option 3: Temporary deferral of the endorsement of IAS 39 as a whole.
Any deferral will only relate to IAS 39.

IBF has examined the proposals in detail and is lobbying the Irish Government representatives on the ARC to ensure that the voice of the Irish banking industry is heard. A deferral would mean that IFRS implementation would continue but existing GAAP would be applied to financial instruments. While we would clearly favour the second option, there are a number of legal questions hanging over such an approach. In particular, it is important in the context of banks located here with overseas parents that any deferral does not prevent them entirely from applying the standard. This could result in certain banks being forced to maintain two sets of record for financial instruments. No vote was taken at the September meeting. It would appear however that a majority of countries favour the 'carve out' approach. There will be a formal vote at the next meeting on 1 October .

What happens next?

FIBI continues to discuss all of these issues with the relevant government representatives and continue to actively contribute to the debate at a European level. In the event that the October ARC meeting brings no resolution, it will be up to the new Commissioner, Charlie McCreevy, to resolve the issue.

Contact: Cathrine Burke 474 8814 - cathrine.burke@ibf.ie or Keith Gross 474 8811 - keith.gross@ibf.ie

Compliance Statements

Begin Preparations Now

Brian Binchy, Research Analyst

At the recent launch of the draft guidance document by the Office of the Director of Corporate Enforcement (ODCE) on these obligations required under the Companies (Auditing and Accounting Act 2003), Director Paul Appleby urged "all concerned to begin preparations now" and he called for responses to this draft document by September 30. Institutions who have already begun examining their processes and procedures would agree that this is prudent advice, because the draft guidance puts forward the option to commence the requirement for financial years beginning on or after 1st January 2005. This would mean that institutions have only until the end of the year to undertake the following tasks:

- identify obligations,
- evaluate current procedures/policies,
- identify any gaps in process,
- devise and implement new policies/procedures,
- communicate new policies/procedures to staff and management and establish monitoring procedures.

Although the finalised guidance will not be ready until October at the earliest, these steps must be initiated now. Needless to say, such a timetable presents an onerous task for directors, compliance officers, auditors and senior managers. FIBI has conveying the difficulties involved to the Director and will make a representation to the Minister for Trade & Commerce Michael Ahern, TD, in seeking a longer lead-in time.

Implications of Central Bank and Financial Services Authority Act, 2004

Members will also be conscious that since 1 August, according to Section 26 of the Central Bank and Financial Services Authority Act of 2004, IFSRA may - whenever it considers appropriate - require a financial service provider to supply a compliance statement. At the Report Stage of the Dail debate, the legislation was amended to allow IFSRA rely on compliance statements prepared under the Companies Act 2003. We will therefore continue to engage both ODCE and IFSRA requesting a harmonised and coordinated approach to the new compliance regime.

Contact: Brian Binchy 474 8812 - brian.binchy@ibf.ie

In our view, the optimum approach would be for an IFSRA oversight role over the existing voluntary industry schemes, thereby ensuring continuity of what are satisfactory schemes from both an Industry and consumer perspective.

If there is to be a statutory scheme, we would prefer to see a single scheme, with industry specific subdivisions, rather than a multitude of statutory and voluntary schemes as we consider that this would create consumer confusion, potential conflicts, expertise constraints and unnecessary costs.

It will also be important to ensure adequate liaison between IFSRA itself, the Ombudsman and the Director of Consumer Affairs to ensure that received complaints are automatically directed to the most appropriate body for redress, without the need to revert to the complainant. This type of mechanism will be of particular value for complaints which, by their nature, may require input from both the Ombudsman and Consumer Director.

We suggest that the scheme be confined to individual consumers, with small businesses continuing to utilise the Small Claims Courts as the primary arena for dispute resolution.

2. Establishment of Consumer and Industry Consultative Panels (Head 14-25)

On balance, we support the establishment of such panels. It will be important to ensure that the panels do not hinder the responsiveness of IFSRA to emerging developments or market events, and that existing channels of communication for interested parties remain open.

We believe that a shorter tenure of office for appointees, say two to three years would be preferable. We believe a rotating membership is likely to better ensure a balance of consistency, representation and freshness.

Selection of the appointees will be critical. We suggest that appointees ought to be nominated by relevant industry associations and consumer groups, as opposed to being purely political appointees.

3. Corporate Governance and Auditing of Financial Institutions (Head 26-34)

As a general observation on this section of the Bill, we would highlight that there appears to be a degree of overlap between certain proposals and existing auditing practice as set out in Practice Notes and Statements on Auditing Standards adhered to by the profession. We would therefore recommend that due regard be given to existing practice in the drafting of the final legislation.

Directors' Compliance Statements

We note that Head 26 is effectively an extension to all institutions regulated by IFSRA of the proposal in the Heads of the Companies (Audit and Accountancy) Amendment Bill, with which we concur in principle. However, we would recommend that, in light of the extensive work and consultation performed in preparing the Companies (Audit and Accountancy)

Amendment Bill, the CBFSAI Bill does not unilaterally alter the requirements of the former Bill without more extensive consultation. The overriding concern has to be to ensure that the process envisaged and the statement required of the Directors is practicable, reasonable and workable.

We welcome the proposed issuing of appropriate guidance by IFSRA, provided this is prepared following appropriate consultation with the professions and industry. This guidance needs to be tailored for the specific needs of the individual industry sectors.

We would envisage that guidance should deal, inter alia, with specifying the particular laws and regulations to be covered by the Directors' statement and identifying the materiality of any instances of non-compliance, which should be reported. Clear and precise guidance will minimise the risk of an unreasonable onus being placed on Directors to establish detailed, expensive and bureaucratic procedures to ensure that any breaches of legislation, even minor ones, are identified.

In relation to the applicability of such compliance statements to the funds industry, we have some particular concerns. The merits of the compliance statement, particularly given the trustee's role, seem limited vis a vis the damage such an imposition may cause to Ireland as a location for these very mobile funds. We therefore suggest that this requirement be considered further and discussed in more detail with the industry.

Auditors' Review Statement

We support the development of guidance for the External Auditors of regulated entities. We believe that the most appropriate means for this to be issued is by the Auditing Standards Board in consultation with IFSRA, in a similar manner to that adopted by the A.S.B. with the Central Bank in publishing the Practice Note on Auditing Banks in the Republic of Ireland.

Power of IFSRA to commission compliance statements, reviews of compliance statements and other reports

We welcome this proposal and recommend that it be availed of in practice by IFSRA.

While current Irish regulators have had equivalent powers under existing legislation, in contrast to other international regulatory regimes, these have neither been universally employed nor consistently applied.

In our opinion there are significant advantages to be gained if IFSRA were to utilise expert third parties to carry out specific regulatory reviews. We believe that it would strengthen the overall regulatory process and thereby Ireland's standing as a financial centre. Secondly, it would facilitate IFSRA in leveraging its own resources more effectively and enable it to gain access to specific industry skills and expertise. Thirdly, and perhaps most importantly, it would ensure that the new regime is sufficiently flexible to enable appropriate and timely action by the regulator.

Regulatory Strategy

The Authority adopted a "principles led" approach to supervision from its inception in 2003, which essentially placed Boards and Management of banks at the centre of responsibility for the prudent conduct of business. The Authority was legally obliged, at least 3 months before the beginning of each year, to prepare a strategic plan and submit this plan to the Minister of Finance. The plan had to specify the objectives of the Authority for the financial year concerned, the nature and scope of the activities to be undertaken and the strategies for achieving these objectives. As soon as possible after receiving this plan, the Minister had to arrange for it to be laid before both Houses of the Oireachtas. When this had been done, the Authority was required to publish the plan and take all reasonable steps to implement it. So, to reiterate, the process was Authority, Minister, Houses of the Oireachtas. The principles-led approach was thus not the sole decision of the Authority. This approach to supervision was followed by all EU countries. The USA is the main proponent of rules-based regulation but this did not protect it from issues with Bear Stearns, Lehman Brothers, AIG, Wachovia and others.

The strategy also set down the objectives of the Authority. One of its objectives was that its regulatory approach would facilitate innovation and competitiveness. It is clear that both of these elements played an important part in the increased availability of credit in Ireland in the years before the crisis, through a combination of more banks entering the market and more innovative types of lending products being developed.

To have taken measures to stifle these developments would have conflicted a fundamental strategic objective of the Authority as mandated by the Minister and the Oireachtas.

In January 2004, a white paper entitled "Regulating Better" was issued by Government to improve national competitiveness. The paper called for wider consultation and more regulatory impact assessment on any new regulations. This illustrates the context in which all supervisory initiatives of the Authority required extensive consultation with a wide range of what were termed "stakeholders"-

-Govt. depts., representative bodies, the Industry and Consumer Panels, banking schools in the Universities. Detailed regulatory impact analysis was extensive. In fact, the Authority also put in place an arrangement with industry called the "Stakeholder Protocol" with enshrined time commitments by the Authority to respond to industry requests for regulatory approvals, issuance of the findings of inspection reports etc. I can understand that initiatives such as this formed a perception of the Authority as a "can do" entity, willing to prioritise industry demands rather than appearing more detached and discerning. This is something which I believe, in hindsight, the Authority got wrong.

In September 2006, the Government published a review of the future of the financial services industry in Ireland entitled "Building on Success". I want to bring two items from the report to your attention:

i. The paper asserted a growing awareness in both Ireland and Europe that poor quality or unnecessary regulation could be a barrier to competitiveness and growth and such regulation could alienate citizens and enterprises through imposing disproportionate compliance costs.
ii. The paper did not propose any increased prudential supervision or suggest a tougher, more burdensome regulatory regime.

The growth in private sector credit arose mainly from the appetite for property acquisition and associated construction activity. This expansion in these areas was due to a number of factors including strong economic growth, an increase in the level of household formation, very low interest rates, lower personal tax rates, a vast range of tax incentives for property investment, the desire of Irish people for property ownership, a "feel-good-element" generated by increasing property values which quickly seasoned loan-to-value ratios, and all supported by readily available bank loans. A further and extremely important factor was the consistent pattern of very positive economic commentary in relation to the performance and prospects for the economy and the property market from the Economic and Social Research Institute, the Central Bank and the Department of Finance.

In formulating its strategy, the Authority always took full account of the output of these authoritative sources, which predicted that the Irish economy would continue to show growth above the EU average and that the property market would experience a soft landing. The Authority relied on the Central Bank which maintained an economic services division with 86 staff, including a dedicated Financial Stability Department, to monitor and assess the overall health of the financial system; there were no economists in Banking Supervision Department. Had these predictions held, there would not have been a bailout.

I do not think, even with the benefit of hindsight, that the Authority, in the context of the time, would have assumed a different approach to supervision. I have come to this conclusion bearing in mind the following:

- The capital requirements in Ireland were higher than the EU demanded;
- The absence of any strong views from the financial stability perspective that a more draconian regime of supervision was warranted;
- The fact that the introduction of a tougher supervisory regime in Ireland compared to other jurisdictions would have conflicted with Government policy to promote the strength and profitability of the financial services industry in Ireland and its attractiveness as an international financial services location.

Witness Statement from Tom Considine to the Joint Committee of Inquiry into the Banking Crisis.

This statement covers the themes and lines of inquiry I was directed to address in respect of my roles as Secretary General of the Department of Finance, March 2002 to June 2006.

Effectiveness of the regulatory, supervisory and governmental regime structure

The role of the Department of Finance was to bring forward to the Minister primary and secondary legislative proposals to maintain an appropriate legal framework for regulating the Financial Services Sector. The Department also represented Ireland in the development of EU legislation governing the regulation of financial services and, in turn, that EU legislation had a strong influence on domestic legislation. By 2002 the bulk of the regulation of the Irish financial sector was the responsibility of the Central Bank of Ireland within the legislative framework provided by the Minister, the Government and the Oireachtas.

The Minister did have an appeal function in relation to the approval of payments systems and he also made appointments to appeals panels and to the Central Bank Board, with the exception of the Governor who was appointed by the President on the advice of the Government. The Secretary General of the Department of Finance was ex-officio a member of the Central Bank Board.

On 20 October, 1998 the Government agreed in principle to establish a Single Regulatory Authority and established an Implementation Advisory Group chaired by Mr Michael McDowell, Senior Counsel. The Group reported on 19 May, 1999 and recommended that the Single Regulatory Authority (SRA) should be an entirely new independent organisation. As a member of the Implementation Group, I proposed an alternative model on behalf of the Department of Finance. This model located the SRA within a restructured Central Bank while providing for increased autonomy for the regulatory function but under the direct control of the Central Bank Board. This alternative model, supported by a minority of the Group, is at Appendix 2 of the report. In the event the Government legislated for a model with a separate Board for regulation but within an overall Central Bank and Financial Services Authority framework. The Regulatory Board was appointed by the Minister for Finance after consulting the Minister for Enterprise, Trade and Employment and did not include a representative of the Department of Finance. The new two board model came into operation on 1 May, 2003.

The Financial Services Regulatory Authority published a Strategic Plan for the years 2004 – 2006. This Plan stated the Authority believed that a mainly principles-based supervisory system would deliver a good balance between having a competitive industry and requiring high entry standards for doing business. That Plan stated that a key part of the approach would be “Putting a comprehensive on-site review process in place”.

The Government’s White Paper “Regulating Better” was published by the Department of the Taoiseach in January, 2004. It identified the principles of good regulation as: Necessity, Effectiveness, Proportionality, Transparency, Accountability and Consistency. The White paper advised that “The recommendations and actions in this White Paper are best seen in the context of the continuing drive for competiveness and people’s expectations of high quality public services”.

The 2006 Annual Report of the Irish Financial Regulator (page 26) refers to its approach to regulation as follows:

> "In order to ensure that our regulatory requirements do not become a barrier to competiveness and innovation, we apply the Better Regulation principles which the Government published in January 2004 (table reference) and are an active member of the Taoiseach's Better Regulation Group"

This approach in turn appeared to be aligned to the prevailing international belief, particularly in the US and Europe, in the economic benefits of rational self-correcting markets and the merits of financial intermediation. For example, in his evidence to this Committee on 18 February last Mr Buti, EU DG for Economic and Financial Affairs stated:

> "Yes, we understood that the Irish housing boom would not be sustainable. But in line with the "Great Moderation" paradigm we, as others, did not anticipate that the end of the housing boom could give rise to the dislocations that eventually emerged after 2007 and which later on lead Ireland to ask for financial assistance from the EU and the IMF. The Financial sector was thought to simply channel funds in an efficient manner to where the real economy needed them. Dangerous excesses were thought to originate only in monetary and fiscal policy making".

The Larosiere Report of 25 February, 2009 gave the following examples of regulatory tools which can help meet counter-cyclical objectives:

> Introducing dynamic provisioning or counter –cyclical reserves on banks in "good times" to limit credit expansion and so alleviate pro-cyclicality effects in the "bad times";
>
> Making rules on loans to value more restrictive; and
>
> Modifying tax rules that excessively stimulate the demand for assets.

However, the Report states that "These tools were not, or were hardly, used by monetary and regulatory authorities in the run-up to the present crisis." Despite the background environment, Ireland did move to increase the capital weighting on high loan to value mortgages and to phase out tax support for a number of property schemes. With the benefit of hindsight, it is reasonable to say that these measures should have been taken sooner.

The Department of Finance was staffed to deal with the functions and regulatory model outlined above and that was considered adequate during the 2002 to 2006 period. The Central Bank and the Regulatory Authority had the structures needed to decide the required staffing levels for the functions they were required by legislation to perform. Clearly, with the onset of the crisis it was necessary for all three organisations to review their staffing and skill levels and to move as quickly as possible to secure and allocate any additional resources required to manage the crisis. With the benefit of hindsight, more consideration could have been given to how the legal framework would cope with a major crisis.

THEME: R1

Effectiveness of the regulatory, supervisory and governmental regime structure

LINE OF INQUIRY: R1c

Appropriateness of the macro economic and prudential policy

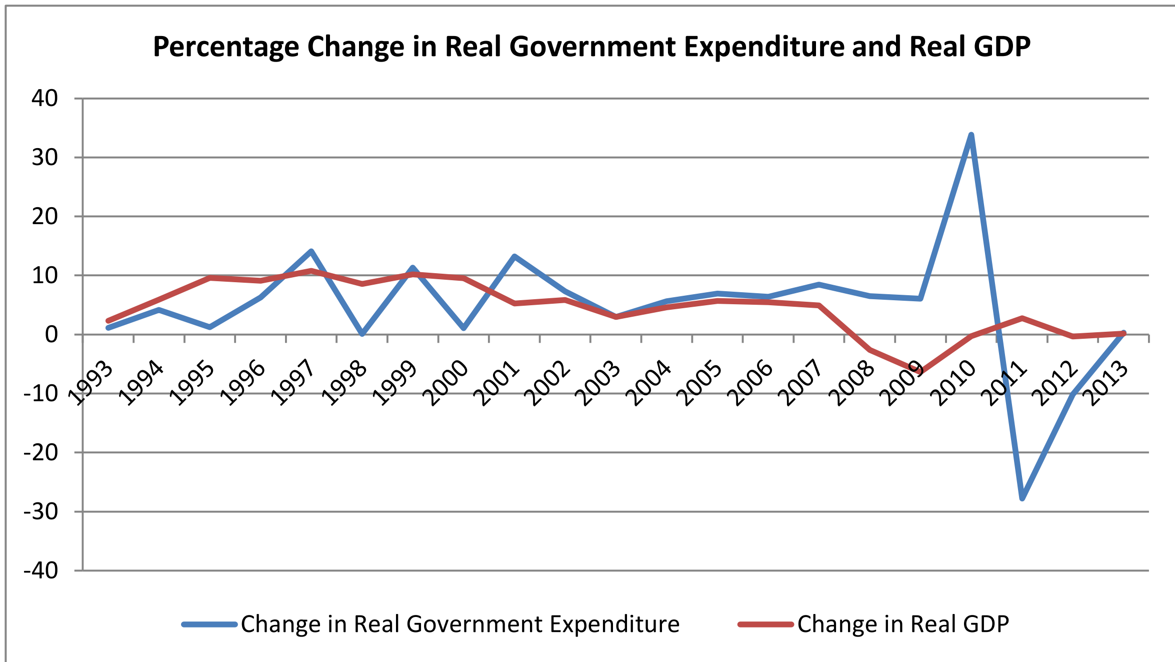
Joint Committee of Inquiry into the Banking Crisis

Data Repository: Selection of Graphs relevant to the Banking Crisis

prepared by

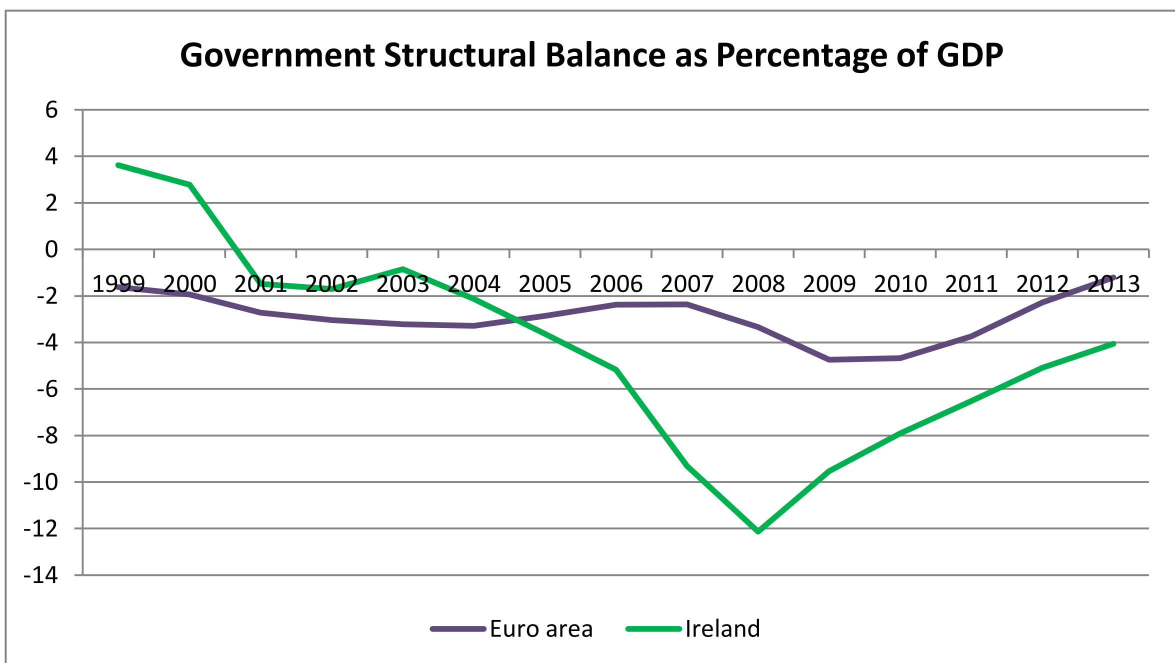
FTI Consulting Limited

Figure 7: Percentage Change in Real Government Expenditure and Real GDP (1992 – 2013)



Source: IMF Data, Advisory Team analysis.

Figure 8: Government Structural Balance as Percentage of GDP (1999 – 2013)

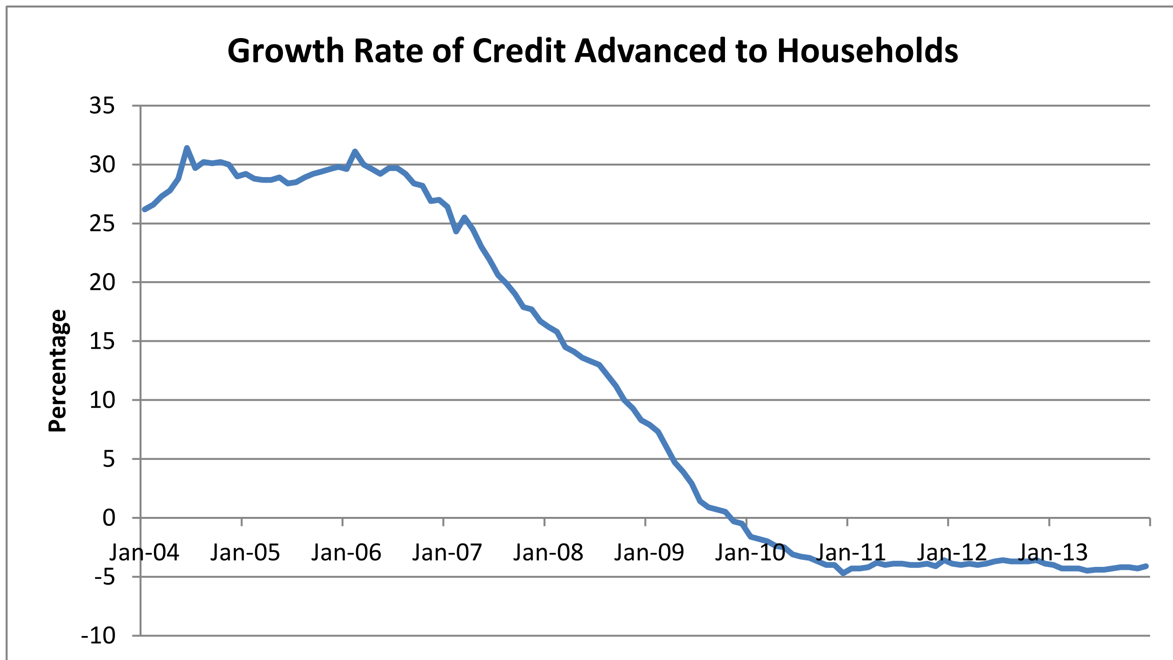


Source: IMF Data, Advisory Team analysis.

Note: Data available only from 1999 onwards.

Banking Data

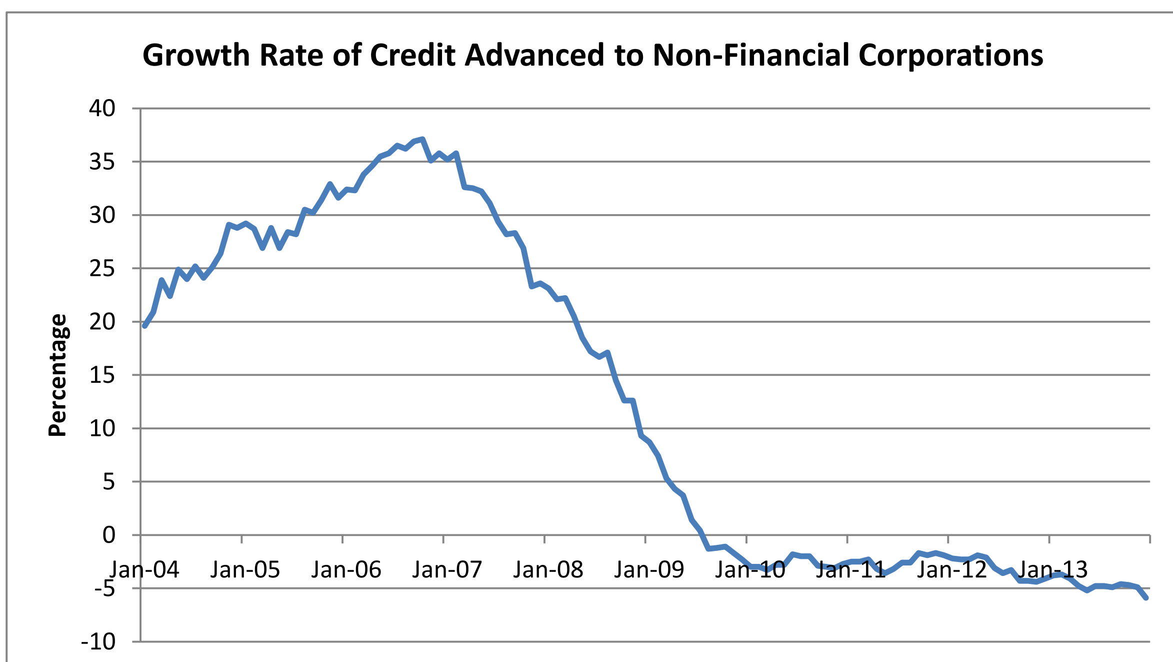
Figure 10: Growth Rate of Credit Advanced to Households by Covered Banks (2004 – 2013)



Source: Central Bank Data, Advisory Team analysis.

Note: Data not available prior to 2004.

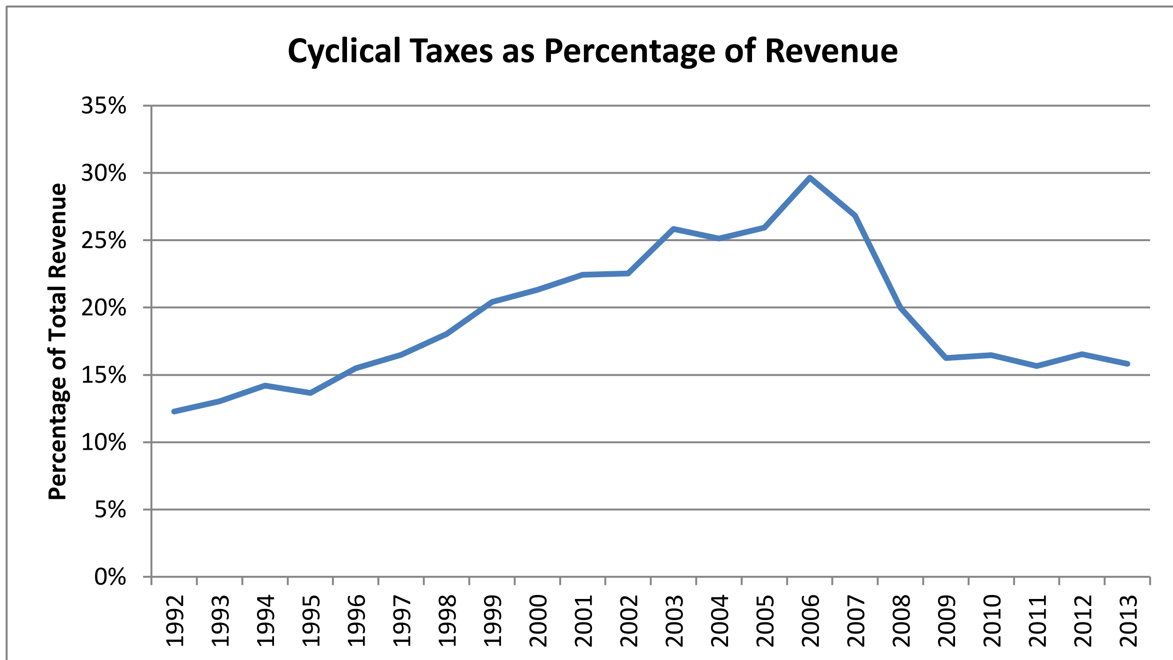
Figure 11: Growth Rate of Credit Advanced to Non-Financial Corporations by Covered Banks (2004 – 2013)



Source: Central Bank data, Advisory Team analysis.

Fiscal/Budgetary Policy

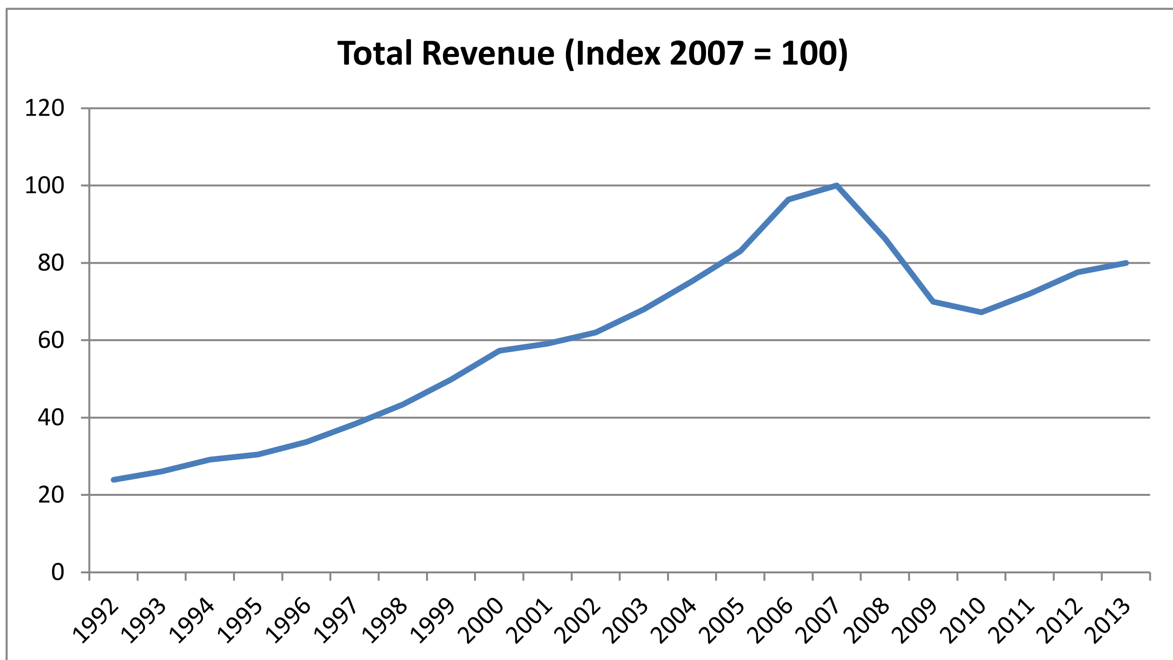
Figure 16: Cyclical Taxes as Percentage of Total Tax Revenue (1992 – 2013)



Source: Department of Finance data, Advisory Team analysis.

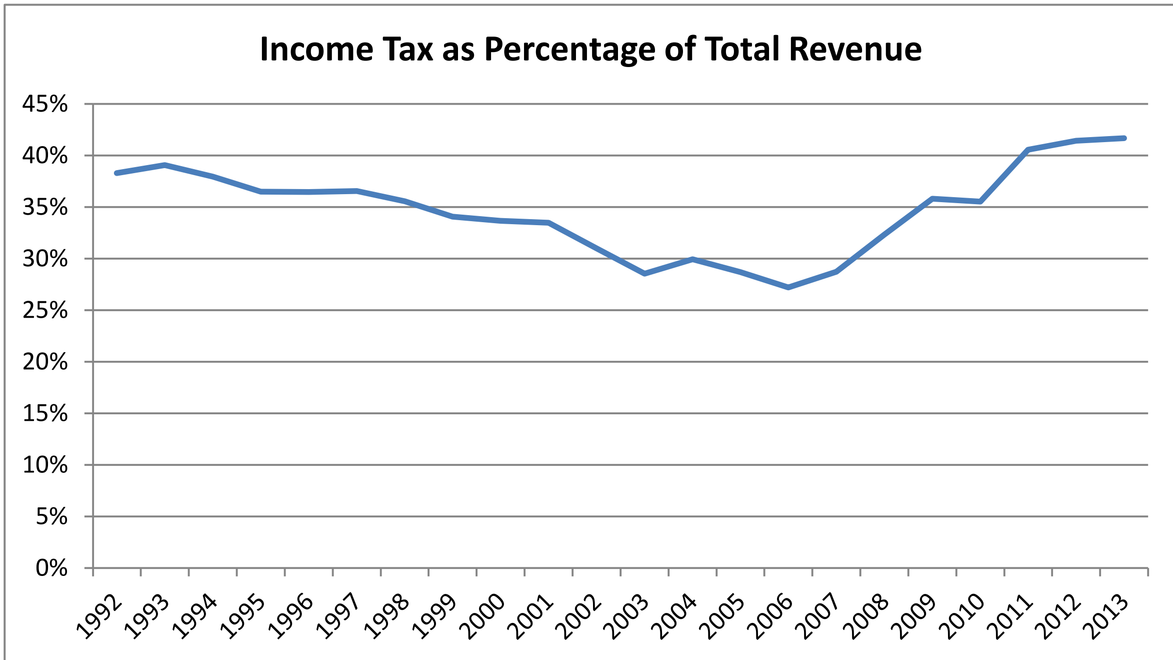
Note: Cyclical taxes are defined as Corporation Tax, Capital Gains Tax and Stamp Duty.

Figure 17: Nominal Total Tax Revenue (Index 2007 = 100) (1992 – 2013)



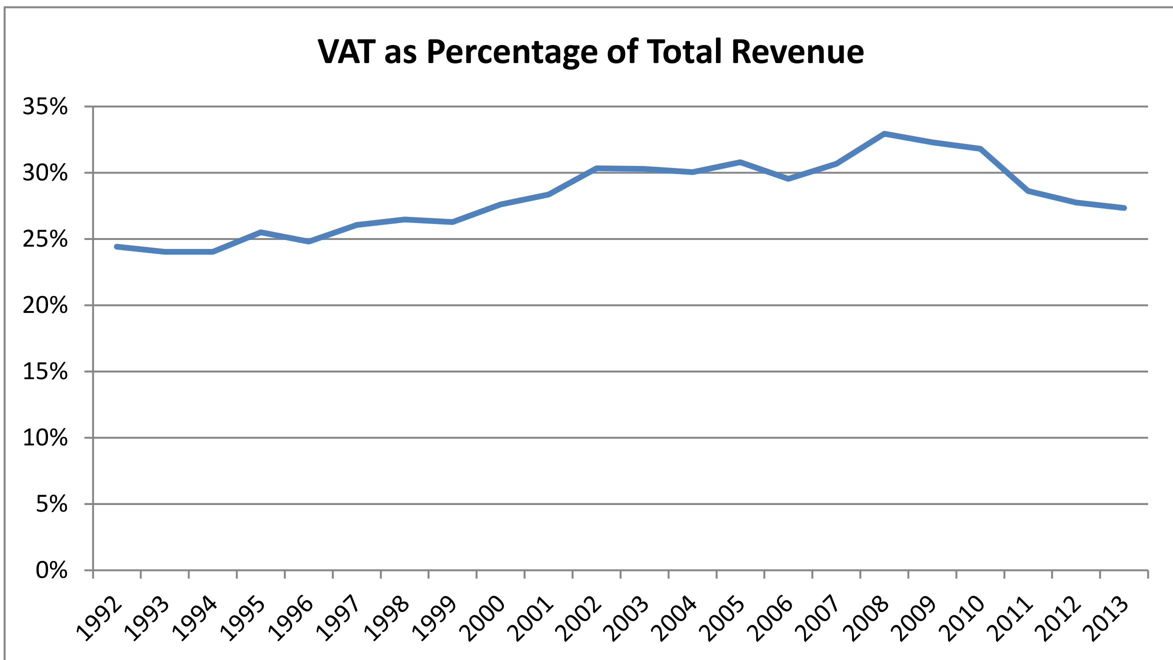
Source: Department of Finance data, Advisory Team analysis.

Figure 18: Income Tax as a Percentage of Total Revenue (1992 – 2013)



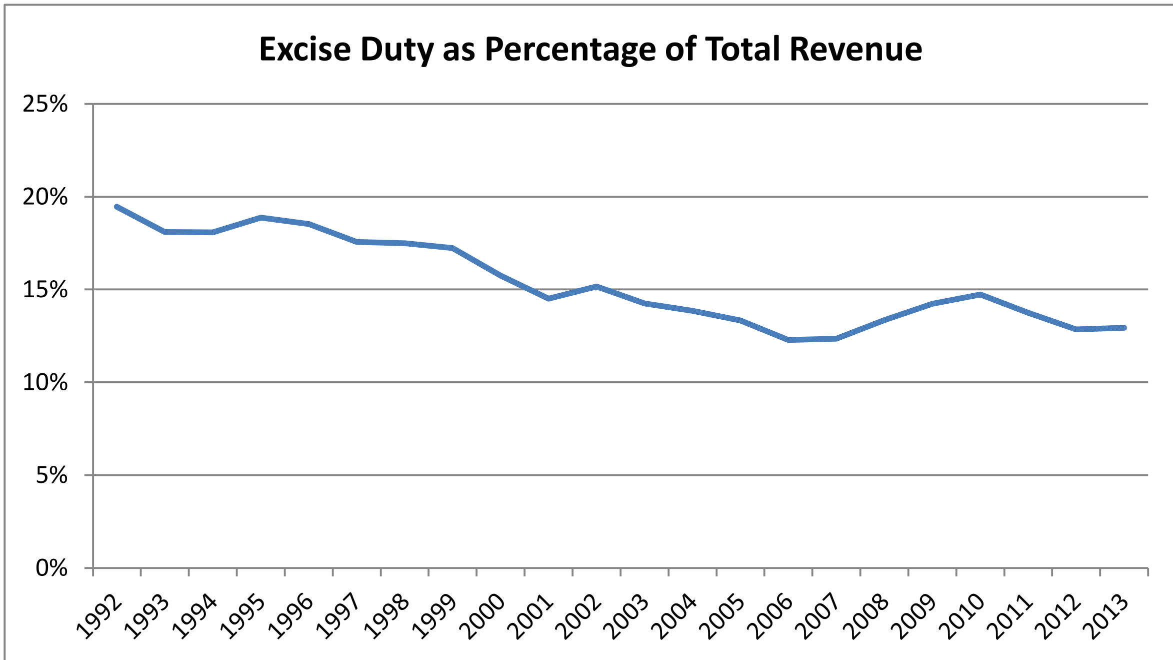
Source: Department of Finance data, Advisory Team analysis.

Figure 19: VAT as a Percentage of Total Revenue (1992 – 2013)



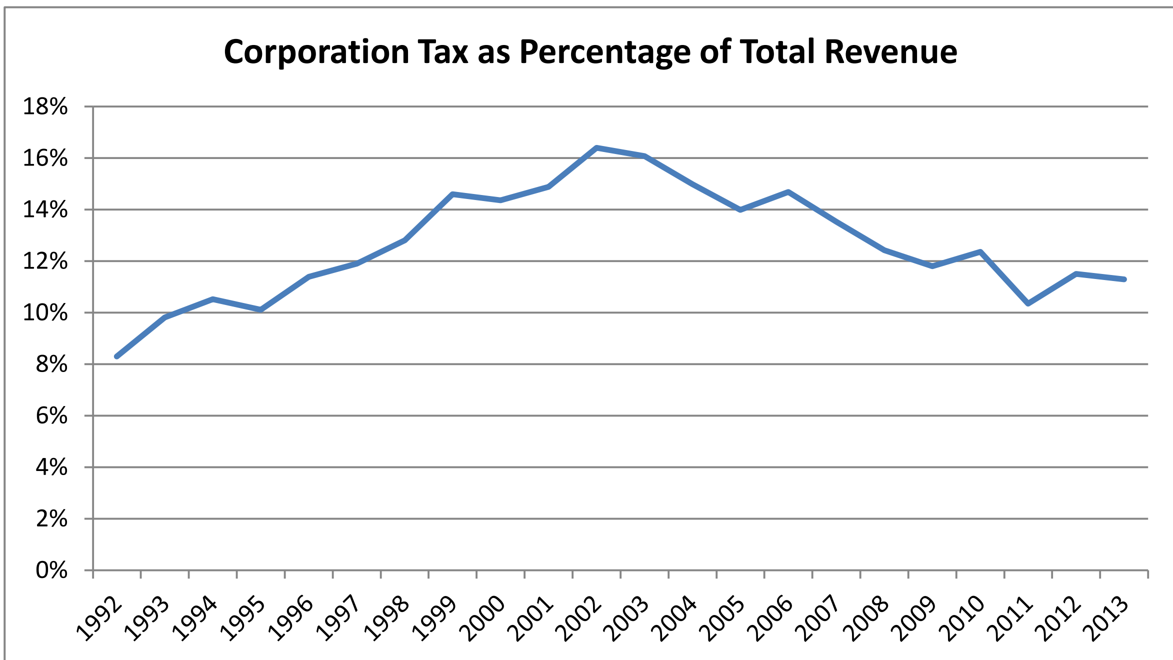
Source: Department of Finance data, Advisory Team analysis.

Figure 20: Excise Duty as a Percentage of Total Revenue (1992 – 2013)



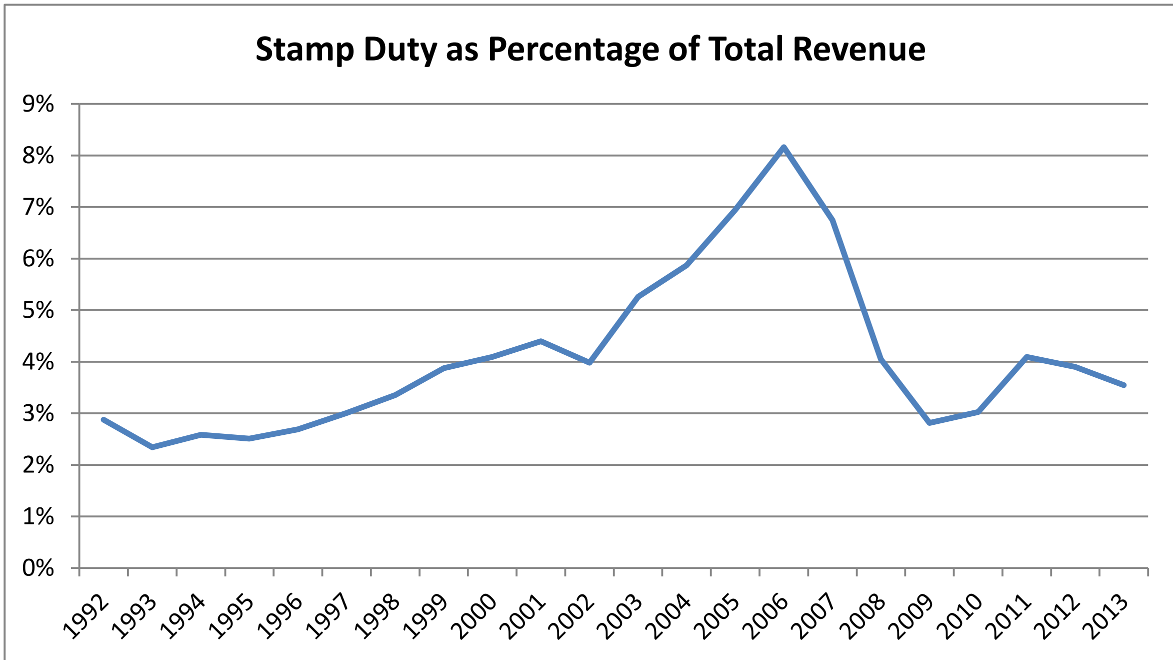
Source: Department of Finance data, Advisory Team analysis.

Figure 21: Corporation Tax as a Percentage of Total Revenue (1992 – 2013)



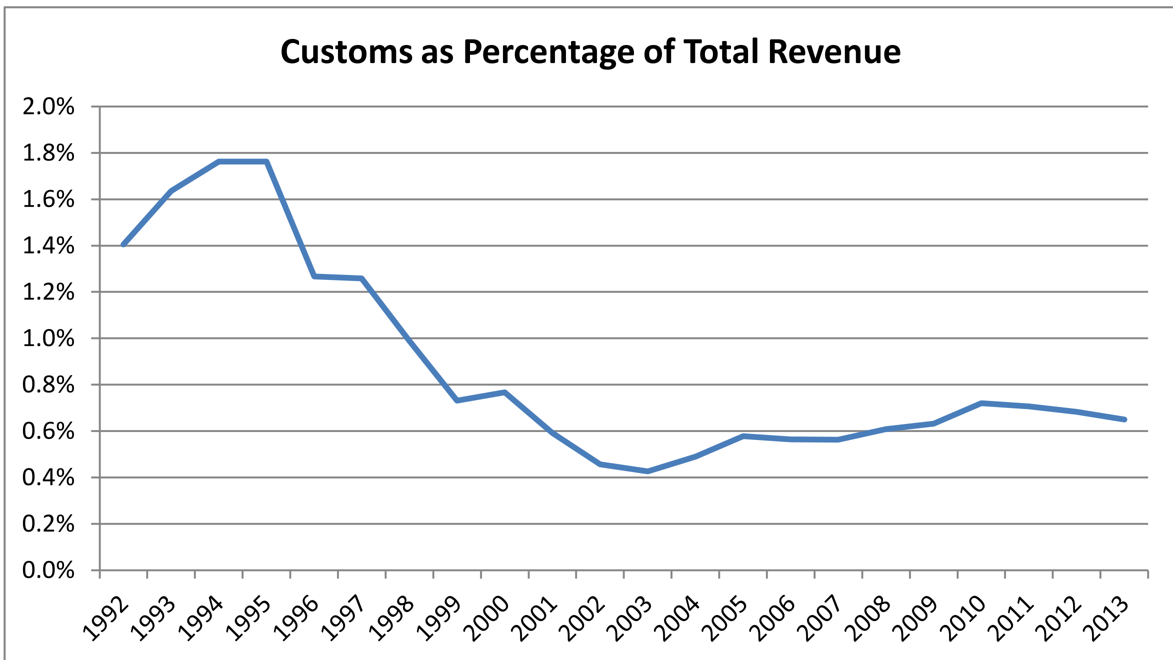
Source: Department of Finance data, Advisory Team analysis.

Figure 22: Stamp Duty as a Percentage of Total Revenue (1992 – 2013)



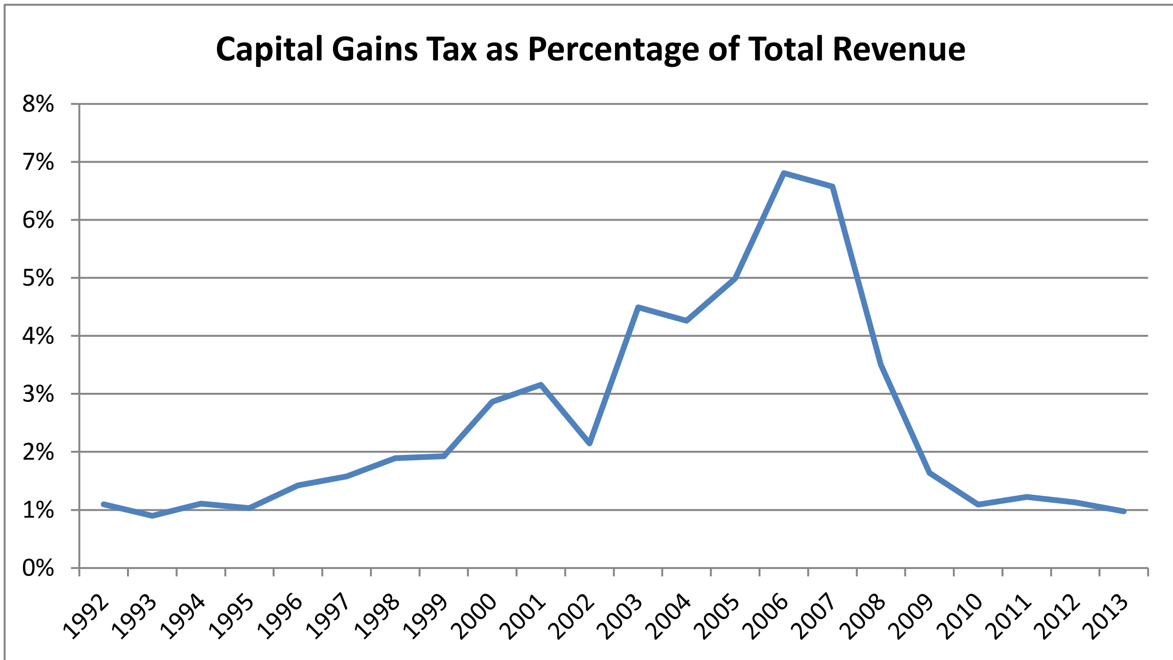
Source: Department of Finance data, Advisory Team analysis.

Figure 23: Customs Duty as a Percentage of Total Revenue (1992 – 2013)



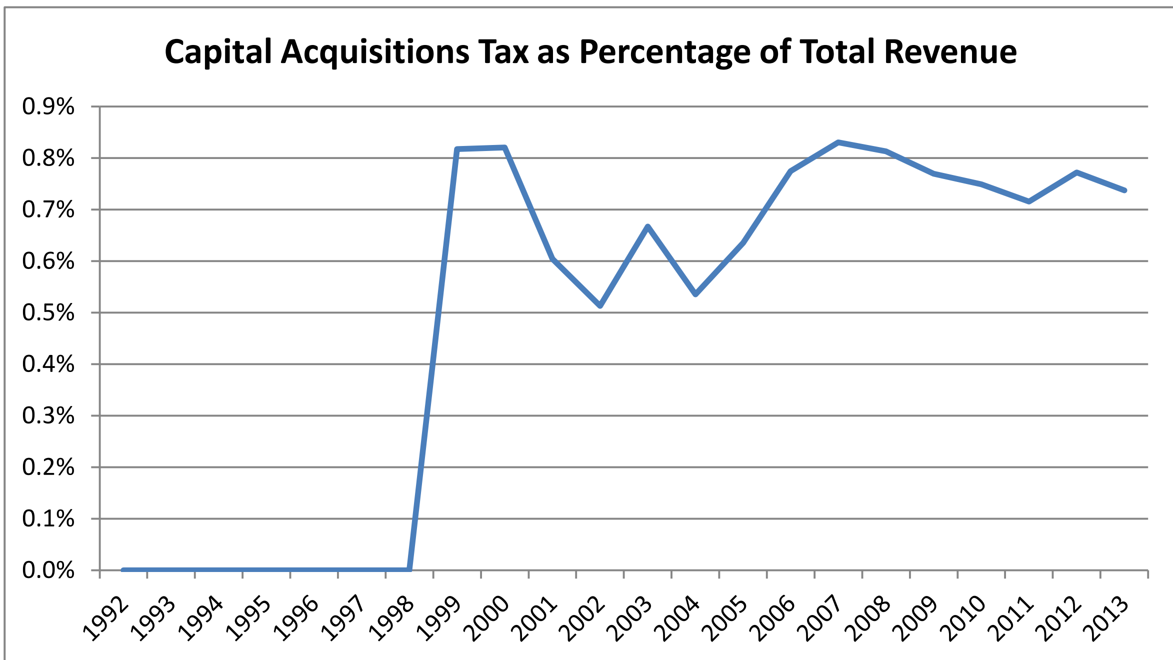
Source: Department of Finance data, Advisory Team analysis.

Figure 24: Capital Gains Tax as a Percentage of Total Revenue (1992 – 2013)



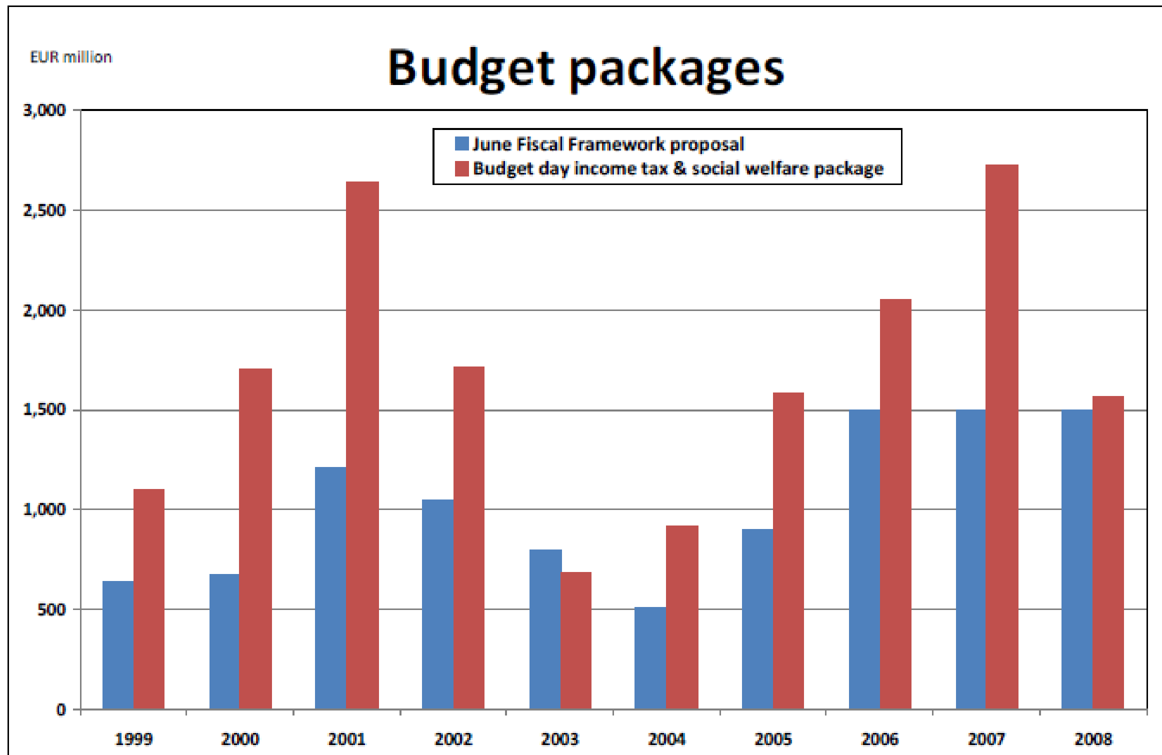
Source: Department of Finance data, Advisory Team analysis.

Figure 25: Capital Acquisitions Tax as a Percentage of Total Revenue (1992 – 2013)



Source: Department of Finance data, Advisory Team analysis..

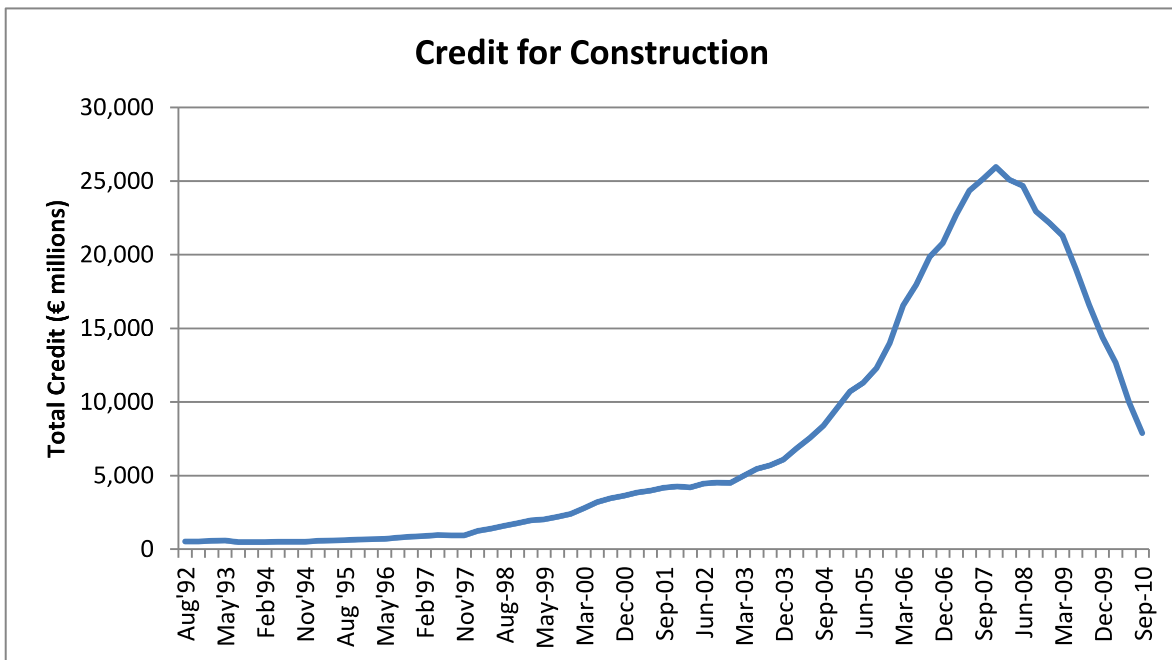
Figure 26: Budget Packages



Source: Wright Report for Department of Finance.

Construction/Property

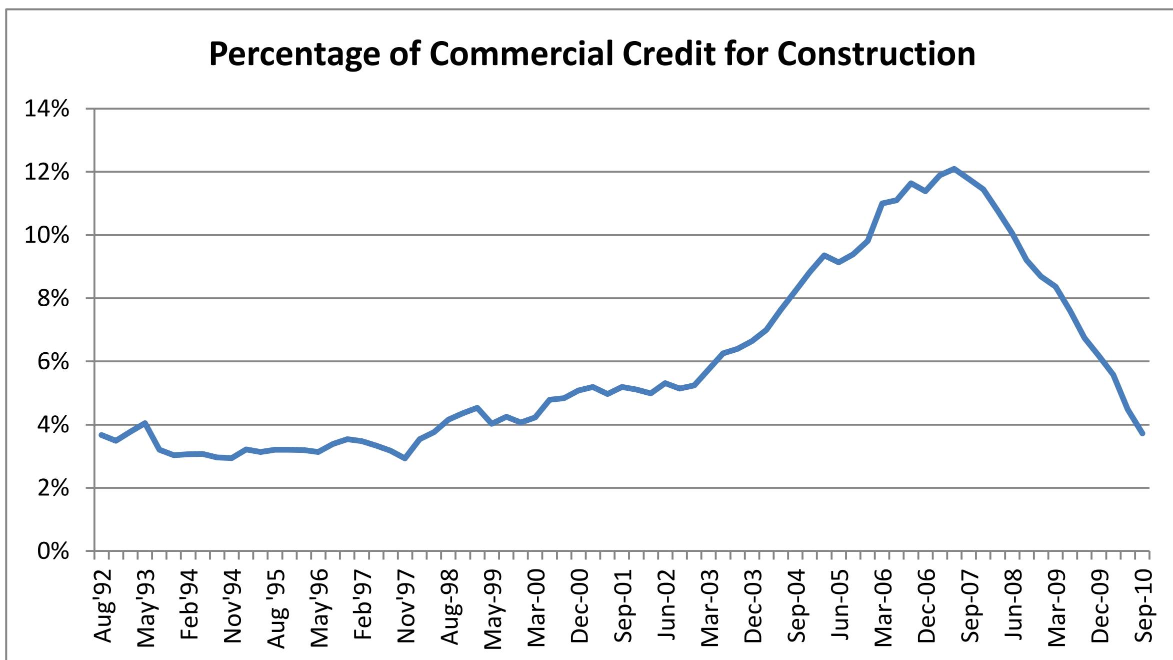
Figure 27: Total Credit Extended for Construction Projects (1992 – 2010)



Source: Central Bank data, Advisory Team analysis.

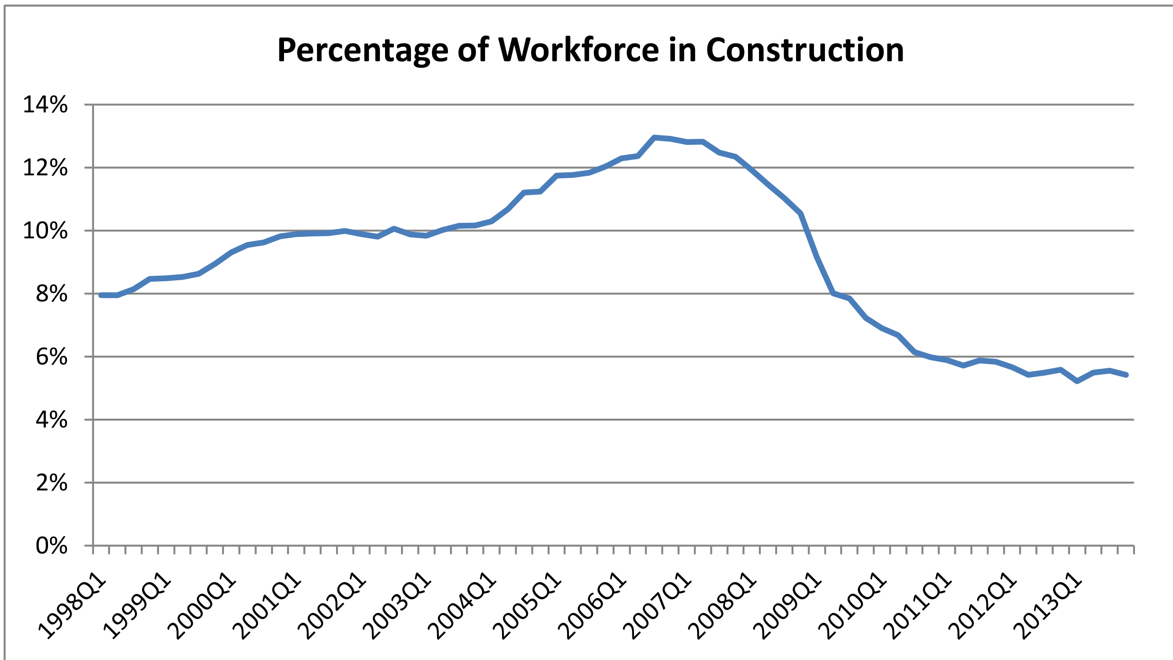
Note: Data series discontinued in 2010.

Figure 28: Percentage of Commercial Credit Extended for Construction Projects (1992 – 2010)



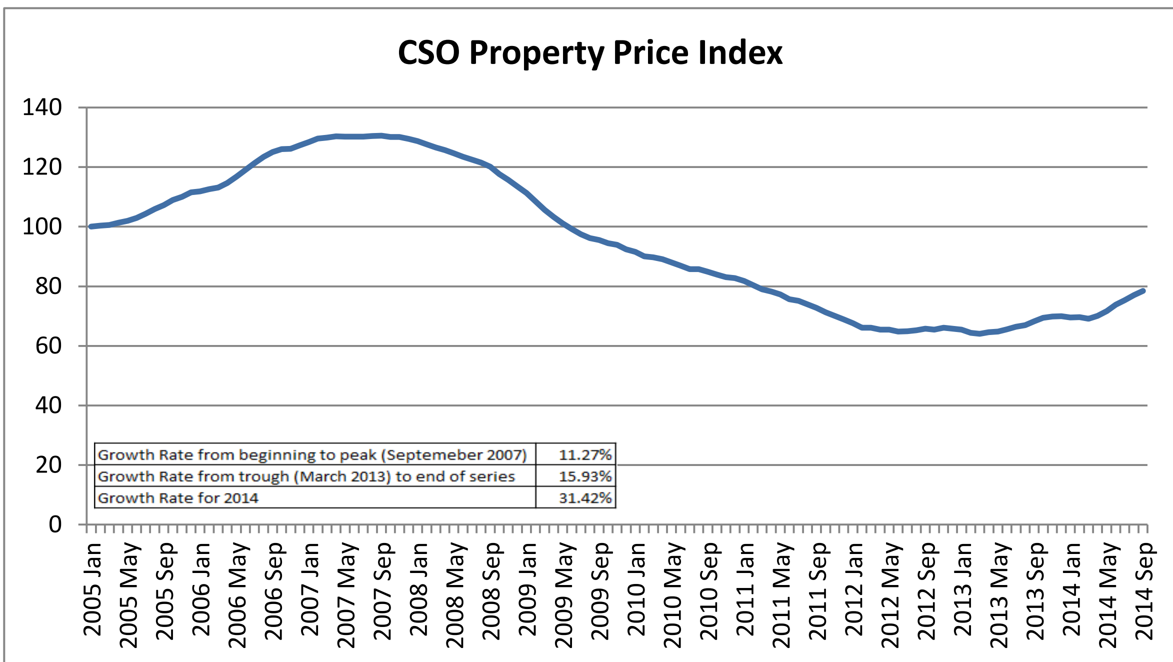
Source: Central Bank data, Advisory Team analysis.

Figure 29: Percentage of Workforce Employed in Construction (1998 – 2013)



Source: Central Statistics Office (CSO) data, Advisory Team analysis.

Figure 30: CSO Property Price Index (2005 – 2014)



Source: CSO data, Advisory Team analysis.

Note: Data only available from 2005

The reports of the Nyberg commission and Regling and Watson suggested that there was a basis for taking some action by about the end of 2005. I've recently re-read some of the relevant documents from that time to get some insight into our mindset. This is not easy with the elapse of close to ten years since the 2005 financial stability report was published. Nevertheless, with the benefit of hindsight, I agree with the view that there was a basis for action in 2005. The Central Bank should have escalated and reinforced its warnings on risks and vulnerabilities at the time. At the time, the bank considered that the approach taken was the correct one and I would like to set out why it held that view.

The Central Bank was aware of plans to phase out tax incentives for property. In October 2004, because of the increases in property prices and also the growth of the property sector, I raised the issue in the Governor's pre-budget letter to the Minister for Finance. I advised that no further extension should be allowed to the termination date of mid-2006 for the range of tax-driven incentives. In the event, a review of tax incentives was announced in the budget in 2004. The review was completed in 2005 and the budget in December 2005 announced their phased withdrawal. The Central Bank was also very much aware that a slowdown in credit growth and property prices was dependent to a significant extent on the future increases in interest rates. It was clear that interest rates would not remain for long at their historic low levels and the Central Bank made this known to other authorities, to the banks and to the general public.

In my introductory comments at the launch of the 2004 financial stability report, I warned that the then level of interest rates did not reflect where the euro area economy would be in the medium to long term. In the round-table discussions with financial institutions in December 2004, the Central Bank representatives pointed out that the equilibrium rate for retail mortgages was approximately 6%. While it could take time to reach that level, it was twice the prevailing rate. The spring bulletin of February 2005 and the summer bulletin of May of that year also cautioned about the effects of rising interest rates on borrowings. The impact of rising interest rates was widely picked up by the media following our reports. One leading newspaper reported that interest rates may double. Other media also gave good coverage to prospective interest rate increases. A further message to the same effect was given at the same time ... at the time of the publication of the financial stability report in 2005 with, again, extensive coverage by the media. In preparing that report, the bank emphasised the psychological impact of the expectation of interest rate increases. In the event, interest rate rises were later than expected by markets because of adverse developments in the euro area. Interest rates did increase in December by 0.25%. This was the start of aggressive monetary tightening, with six further increases of the same amount in the period between December 2005 and March 2007. Because of the importance of the effect of interest rate rises for credit growth, the Central Bank's warnings on prospective rate increases were persistent and strong.

Towards the end of 2005, house price growth eased considerably as part of an international trend. The real price index of commercial property, as the Nyberg commission shows, was fairly flat since about 2000. The Central Bank considered that increases in interest rates were the most effective way of cooling the property market and, with a lag, easing credit growth. The bank also considered the exchange rate to be an important factor in slowing the economy. The euro appreciated by 35% and 12% against the dollar and sterling, respectively, between 2000 and 2005. As indicated, the decision of the Minister for Finance to phase out the tax incentives for property was also expected to play an important part. So too were the measures being considered by the Financial Regulator on risk ratings for high LTV mortgages and speculative commercial property. The bank considered that this range of measures should be sufficient to reduce the growth in property prices and, later on, credit. However, it wasn't until about 2006

whereas heading a Central Bank needs ... to act, to be decisive, to take decisions ... under the 71 Act, albeit your interpretation was not to issue the kind of guidelines ... as some of the rest may interpret from the Honohan letter ... but did that hamper your ability to do that? In essence, were you qualified enough to do the job with the benefit of hindsight?

Mr. John Hurley: Well, as you look around, the governing council table you'll see that quite a number ... or maybe at a certain stage, a majority of people would have come though the same path ... would have had the same experience ... and would have been a ... come from ministries of finance. You're given a different role and the role then gives you an independent role - to give advice and to ... to ... to carry out that advice. And that's done in the form of the publications that were issued and the press conferences I held. I think, Deputy, if you look at the press coverage over the years, you will find that I was praised for being at loggerheads with the Government on occasion because I had to stand up and say things that weren't appreciated. And that's in the press coverage. So, the reality is you have to take an independent line and you have to do and say things that are the responsibility of a Central Bank. But the ... the career path in the governing council ... of the majority of the people at the particular moment in time would have been very like my own.

Chairman: Okay, thank you. I just need to deal with one matter before I move on. And that's just to come back to Senator MacSharry's earlier question is ... can you comment upon your relationship with the Ministers for Finance ... Minister McCreevy and Minister Cowan during your tenure as Governor in terms of regularity of meetings that you would have had with them on an annualised basis? Just in the documents that we would have here before us ... it ... it would show that you would've had scheduled meetings on a regular basis with the Minister for Finance at that time. If you could maybe comment with regards to the regularity.

Mr. John Hurley: I think mostly the meetings ... I can't put an exact time on them because maybe the ... the formal meetings might be once every two months or more ... seven or eight meetings a year. But, of course, we would be meeting in addition to that, outside the formal meetings, at the different fora and at different events. What ... as ... as a matter of course, meetings were arranged particularly around ... at the time of publications or at the time of issuing letters to the Minister. You would always take the occasion to have a discussion in those ... at those times. So, it was fairly frequent and there was never an occasion where a request for a meeting was denied.

Chairman: Under the ... because of section 33AK, I'm not going to bringing diary schedules up. But it would indicate that the meetings took place between 2001 and 2007 maybe seven to eight times annually, would that be correct?

Mr. John Hurley: That would be right, yes.

Chairman: Okay, and-----

Mr. John Hurley: Formal meetings but of course you would meet much more frequently than that.

Chairman: And in or around 2003, it would seem to indicate that meetings should be held with economists and senior loan officers, lending managers at the banks with the view to communicating the Central Bank's opinion of financial stability issues to them. Would you further like to ... would you further like to elaborate upon that?

Mr. John Hurley: That ... that was I think the gestation of the round-table discussions with

R1c – Appropriateness of the macro economical and prudential policy

R5c – Analysis of key drivers for budget policy

Information Summary (Section 33AK)

Note: All references are aggregated.

Document category	Time period
CBFSAI papers and Board discussions relating to • Macro-economic performance • Financial Stability Reports • Pre-Budget letters • Related economic reports	2004-2007

Financial Stability Report: 2004

- Staff of IFSRA contributed to the preparation of the report under the aegis of the joint Financial Stability Co-ordination Committee. The presentation of the report was noted as a good example of close cooperation between the two sides of the organisation.
- A presentation was made to the CBFSAI Board on the different methodologies used in assessing whether or not there was now a house price bubble in Ireland and the ability of the banking system to withstand a sharp fall in property prices.
- The Committee noted the following points:
  - interest rates were now determined by the ECB on a euro system basis.
  - credit growth was not a problem in the euro area as a whole however the Bank's capacity to restrict the rate of credit growth was very limited.
  - possible options on restricting credit growth were being considered but the Bank was not aware of any actions being taken by other national central banks in the Eurosystem which the Bank was not already taking.
  - the Bank continued to alert the industry and the public to the risks of excessive credit growth.
  - property prices were continuing to increase at an unsustainable level but there was no conclusive indication that a price bubble existed.
  - If prices continue to increase, however, the risk of a price bubble would become more acute.
  - a collapse in property prices would not only affect the quality of security for bank loans, it would also have widespread economic implications as the construction industry was now a very major component in the Irish economy.

CB00222

Pre-budget letters and budget: 2004

- The CBFSAI Board discussed the draft annual pre-budget letter. The draft contained the following statement: "*Fiscal policy could also play a role in smoothing the adjustment of demand for property by limiting its more speculative components. In this regard, it would seem appropriate, for example, to allow no further extensions to the termination date of mid-2006 for the range of tax driven incentive schemes for housing.*"
- The need to limit overheating pressures to protect competitiveness was also mentioned. The letter included the following statement: *"In fact, a case could be made for a mildly restrictive stance in the context of full capacity growth*."
- Regarding the overall budget balance, a broadly neutral stance was being recommended. In reviewing the draft letter, it was agreed that the Bank should emphasise risks regarding the economic forecasts.
- The Governor advised the Board that he would issue the letter after meeting the Minister. Later in the quarter, the Board noted that the Governor had met the Minister for Finance before issuing the pre-budget letter.
- After the budget was announced, the Board discussed the budget outcome and it was noted that the advice from the Governor was not fully adhered to.
- Private sector credit growth was discussed but no recommendations were made to slow this down.

CB00231 & CB00260

Autumn bulletin: 2004

- Regarding the content for the "Autumn Bulletin", the CBFSAI Board had already addressed the risks to the housing market in some detail in the Financial Stability Report.
- It was agreed that further commentary on the housing market would be unnecessary and that commentary should focus on the broader economic perspective and outlook.

CB00241

Discussion on the content of the bulletin focused on the fiscal imbalances in the US rather than on the domestic problems with credit growth and house price inflation.

CB00249

"Economist" Articles on the Irish economy: 2004

- A series of articles on the Irish economy, published by the 'Economist' magazine in October 2004 was discussed at CBFSAI Board Level.
- Emphasis of the discussion was on the positive aspects of the series.
- The minutes do not show discussion on the mention of the 'property frenzy' or 'house price bubble'.
- The articles also highlighted a property crash as the most threatening risk ahead.

CB00247

Draft Financial Stability Report: 2005

- In relation to the comments included in the draft Financial Stability Report 2005, the CBFSAI Board noted that, in the absence of national control of monetary policy, it was particularly important that the Minister be fully informed regarding the Board's concerns when framing fiscal policy and the Governor will bring the issues to the attention of the Minister.

CB00331

Spring Bulletin: 2005

- A draft comment for inclusion in the Spring Bulletin 2005 noted the following on the importance of the construction sector:

"*With the strong performance of the construction sector in recent times, this sector now accounts for nearly 12 per cent of total employment; this share is about 50 per cent greater than in most other developed countries. At some point, the share of construction in total employment will inevitably be reduced. It will be important to ensure as far as possible that this labour can be absorbed into other sectors of the economy without disruption*."

"*Regarding mortgage credit, although it appears to have peaked, it is still increasing very rapidly at about 25 per cent a year; this is some three times the increase in nominal disposable income. The easing of house price increases and somewhat reduced housing construction should, with a lag, contribute to a lowering in credit increases to a more sustainable pace. However, until there is some evidence of this, mortgage credit growth continues to be a matter of concern*."

CB00286

Financial Stability Report (FSR): 2005

- There was a CBFSAI Board discussion on the draft Financial Stability Report (FSR) for 2005 of potential actions to be taken by both the Authority and the Board in response to the risks outlined in the Report.
- It was agreed that further analysis would be undertaken of credit growth to assess whether "*there are grounds for serious concern*".
- The Bank was to further examine the real risks to the system and to reflect its considered view in the published Report.
- In a later discussion of the final draft of the FSR, it was agreed that the tone of the published version of the FSR "*should not be too strident because fundamentals help to explain, to a significant extent, the developments to date but it was important to emphasise the risks going forward*".
- It was confirmed that the Report would be published with a press conference and the Director General and the CEO of the FR would chair a further round table meeting with the principal lenders to discuss messages from the Report.

CB00331

Central Bank Strategic Plan: 2007-2009

- The Central Bank 3-year Strategic Plan was discussed by the CBFSAI Board in mid-2005.
- Key extracts from the Plan relating to CBFSAI responsibility are below:

"*Use our economic, financial and monetary expertise, and our institutional independence, to influence other domestic policymakers; and ensure that other policymakers have the information and tools available, to take decisions on policies that support low inflation, growth and financial stability*".

"*The financial system has evolved as a more global, integrated and complex system. This has led to greater financial stability and risk management challenges for the Central Bank, including*

- *managing and aiming to reduce economic, financial and operational risks;*
- *balancing the financial risks we are willing to bear on our investment assets, against the rate of return we are aiming for;*
- *developing crisis management procedures and business continuity arrangements, to be in a position to deal with major disruptions to financial activity or to the financial system*".

"*We must take account of the economic and financial environment facing the Government in carrying out our responsibilities. These issues include:*

- *Greater pressure on Government policies to be in a position to support growth and low inflation, now that monetary and exchange rate policy can no longer be used for Irish purposes;*
- *Pressures on the public finances, given Ireland's need for infrastructure development; and*
- *Balancing Ireland's growing responsibilities in the international community with the need to ensure the domestic economy is safeguarded*."

"*Enhancing our crisis management procedures despite international best efforts to forecast and try to mitigate financial risks, crises can still occur. On*

those rare occasions, it is essential to deal with the damage caused as quickly as possible. We have developed a domestic crisis management framework and are also involved in developing the framework for the EU. We will continue to review and test these procedures, to ensure that they are well geared for dealing with any such events."

CB00309

Household Mortgage Indebtedness: 2005

- A paper on household mortgage indebtedness which was presented to the CBFSAI Board examined whether the personal mortgages-related aspect of growing indebtedness was capable of being explained by developments in the macro economy and banking sector over recent decades.
- It also warned of potential risks from a deterioration of the 'fundamental driving forces'.

CB00364

Steps taken to deal with Financial Stability Risks: 2005

A document outlined steps taken up to Q3/2005 to deal with Financial Stability Risks, as follows:

Macro-level:

- Publications – most importantly FSR,
- Roundtable discussions with banks,
- Stress testing,
- increase Consumer awareness;

Micro level:

- On-off site monitoring,
- specific measures around 100% LTV mortgages,
- meetings with CEOs of banks.

CB00368

Pre-Budget letter and budget: 2005

- The letter commented on the macro-economic situation mentioning the high level and rapid increase in the private sector credit, and an expectation of a gradual decline in housing output, "*however, a more abrupt adjustment cannot be ruled out*".
- The letter recommended a limitation in any indirect tax changes in the 2006 Budget, and in its summary called for a prudent approach to the fiscal stance next year.
- An assessment paper of the budget measures announced later in the year mentioned in its conclusion that it pointed to relaxation of budgetary policy in 2006.

CB00129

"Euro Area and International Developments": 2006

- A Table showing Private Sector Credit Growth, Residential Mortgage Growth and Irish Contribution to Euro Area Money Supply (M3) was included in monthly reports "Euro Area and International Developments", which were distributed before all CBFSAI Board Meetings.
- Private Sector Credit growth is shown as follows:

Year	%
2003	17.9
2004	26.6
2005	28.8
2006[1]	28.2 – 30.3

- Similar numbers were reported for Residential Mortgage Lending Growth.

CB00469

[1] first 8 months of 2006

Property risks: 2006

- The Regulator briefed the CBFSAI Board meeting:

  - on proposals under consideration to increase the capital weighting for residential mortgages where the loan to value ratio of mortgages exceeds 80 per cent and introduce a more rigorous stress testing;

  - on the intent to introduce higher standards "in agreement with the Industry" without publicity as the Regulator would not wish the measures to unsettle the market;

  - that, from discussions with the chief lending institutions, the proposals did not appear to raise competitiveness concerns;

  - that discussions would also be held with the Department of Finance before the measures were introduced.

- In a later meeting, it was noted that the Financial Regulator would convey the message to the market that the increase in the risk weighting on certain categories of mortgages should be seen as a relatively low key prudent measure targeted at a specific category of loans and not as an attempt to curtail the availability of credit for house purchases.

CB00391

Macro economy: 2006

- The Governor had met with the Minister for Finance on the Board's views on the domestic economy and the international outlook in accordance with the established practice for periodic meetings.

- The CBFSAI Board considered the commentary for the Spring Bulletin, with inclusion of a risk of a sharp correction in house prices and rising ratio of personal debt to disposable income besides others.

CB00405

- The Board discussed tax dependency on the house price boom which included the following considerations:

> *"the Exchequer is benefiting strongly from the booming construction sector and the large tax take from it. As indicated, the scale of this sector must contract in due course with a likely sizeable adverse effect on tax revenues"*.
>
> *"These developments have served to increase the economy's already high dependence on the health of the broad property sector to an extent that constitutes a significant risk*."

CB00395

- The Governor briefed the Board on a "substantive" discussion which he had with the Minister for Finance at which he had elaborated on the Bank's views on the economic outlook.
- The Governor briefed the Board that he would also be meeting the Taoiseach after the summer to discuss the economic outlook in advance of preparatory work on the Budget for 2007.

CB00454

Report entitled "Is there a homogenous Irish Property Market?": 2006

- The CBFSAI Board considered a report entitled "Is there a homogenous Irish Property Market?"
- The question addressed in the report was whether, based on historical experience of the property market, any fall in Irish property prices could be expected to occur across all segments simultaneously.
- Key findings included:
  - a high degree of correlation between all residential property types and residential locations;
  - the retail sector had grown at a relatively stronger pace in recent years by comparison with the office and industrial sectors;
  - while the correlation between retail and commercial property was smaller, statistics showed that significant correlation existed.

- On the question of publication, it was agreed that it was important to get the message conveyed in the Report across to lending institutions.
- Consideration would have to be given as to how this should be done as the Bank would wish to avoid provoking an "over-reaction" to the findings.
- It was agreed therefore that the message should be conveyed in the Financial Stability Report.

CB00445

Interim Financial Stability "Update on Risks and Vulnerabilities" Report: 2006

- This document raised the alert on the financial stability risks from private indebtedness, re-accelerating house price growth and strong loan volume growth of the Irish Banks.
- It also raised concerns on the strong rise of loans to commercial property-related non-financial corporates, which had played a minor part in the commentary of former Financial Stability Reports to date.
- Liquidity issues were also raised:

> "*the funding gap continues to widen, suggesting that the risk of a country-specific shock could pose liquidity or refinancing risks for banks*".

- The CBFSAI Board reviewed the assessment in the Draft Financial Stability Report in detail.
- It was agreed that the main issues identified in the Report were the key concerns and the issue would "increasingly arise" as to whether there was any further action which the Bank or the Financial Regulator can or should take to address the risks.

CB00396 & CB00442

Pre-Budget letter: 2006

- The pre-Budget letter to the Minister for Finance was considered. While pointing out a number of specific risks, the letter ultimately recommended a "*broadly neutral Budget for 2007*".
- Domestic risks were outlined in the text:

"*There are also a number of domestic risks, principally surrounding the housing market and the construction sector generally. The re-acceleration in house prices this year is a particular concern, as this upturn does not appear to have been driven by fundamental factors. It seems that a gap may now be opening up between actual prices and prices warranted by fundamentals. International observers such as the IMF and OECD have produced estimates of an overvaluation in the range of 15 to 20 per cent.*

Another indicator that house prices are becoming overvalued is that, based on a debt-service threshold of 40 per cent of disposable income, an increasing proportion of potential buyers are being priced out of the market.

The weight of the construction sector in the economy has increased markedly over the last decade, accounting now for 13 per cent of total employment, an exceptionally high ratio by international standards. Allowing for indirect effects, it would seem reasonable to assume that currently about one in every five jobs is reliant on the construction sector".

"This points to the need for fiscal policy to avoid incorporating too optimistic a scenario for the construction sector and to target a sufficiently comfortable budgetary position to absorb any sudden downturn".

"*Given that the overall price level in Ireland is 23 per cent higher than the EU average and inflation is once again significantly in excess of the euro area average, there is a strong economic argument that the forthcoming Budget should not be framed so that it will contribute to inflation".*

"With the economy operating at around full employment, it would be preferable to avoid a pro-cyclical fiscal stance in 2007 - a message also

conveyed in the recent IMF Article IV report on Ireland. A stimulus to demand can only heighten the risk of exacerbating inflationary and competitiveness pressures to the ultimate detriment of good economic performance."

CB00457

CBFSAI Board meeting: 2006

- It was confirmed that the Minister for Finance was to brief the Cabinet on the Authority's decision to increase risk weightings on mortgage loans and that the consultative panels were to be advised of the decision.
- The Minister's agreement was being sought not to levy the Industry with the Financial Regulator's costs in 2006 associated with the new Market Abuse Directive.

CB00442

Macro-economy: 2007

- Discussion was held in the CBFSAI Board on the first fall in house prices and its potential implications for the economy, the Exchequer and employment.
- The price sensitivity of building land and potential impact on those who had large holdings in building sites was mentioned.

CB00528

Draft Financial Stability Report: 2007

- The Draft of the FSR was discussed in a CBFSAI Board Meeting.
- The first sentence of this draft ended in an option to choose the preferred wording: "*The overall assessment is that financial stability risks have on balance [remained unchanged/very slightly increased] since the 2006 Report*."
- The following key points were raised:

> "*While this has reduced the vulnerability posed by the previous substantial increase in house prices, it increases the uncertainty regarding the future path of prices*."
>
> "*Many commentators have cited arguments in favour of a sharp downturn, namely, the international evidence on house-price cycles, uncertainty over investors' participation in the property market as capital returns are eroded, the sustainability of current rates of immigration and the future direction of monetary policy as important issues. However, the evidence is not convincing on the likely negative impact of these factors. Furthermore, the underlying fundamentals of the residential market appear to be strong and the current trend in prices would seem not to imply a significant correction. The central scenario is, therefore, a soft landing*. "

CB00545

The 'tone' of the 2007 FSR report was discussed:

> "*Following the presentations, there was a detailed discussion on the content on the draft Financial Stability Report. The meeting considered that in the continuing turbulence and uncertainty in the financial markets since early August, the tone and comment in the Financial Stability Report will be of particular importance and sensitivity*".
>
> "*Care should be taken to ensure that risks are set in context of the strengths of Ireland's strong economic performance and prudential environment*."

CB00584

- It was agreed that particular care should be taken to ensure that comment on risks are not liable to over-interpretation by the international and

domestic media. In this context it was suggested that a Box entitled 'House Price Booms and Busts: the International Experience', could be over-interpreted.

- The fall in house prices was also considered:

> "*However, the evidence is ambiguous on the likely negative impact of these factors, the underlying fundamentals of the residential market appear to be strong and the current trend in monthly price developments does not imply a sharp correction. The central scenario is, therefore, for a soft, rather than a hard, landing*."

- International market turbulences were considered:

> *"The international banking system has been affected directly through losses on their US subprime assets and indirectly through holding of investments exposed to US subprime losses, from credit commitments to conduits/special purpose vehicles, and from a general disruption to business. As is the case for banks worldwide, liquidity pressures in the interbank and commercial paper markets are likely to be an issue for the domestic banks. However, the domestic banks report no significant direct exposures to US subprime mortgages and very limited exposures through investments and credit lines extended to other financial companies or special purpose vehicles. The domestic banks' shock absorption capacity does not appear to have been much reduced by these events."*

CB00566

Liquidity: 2007

- The liquidity turbulences were discussed on the CBFSAI Board and the low level of interbank lending for longer periods (over one week) was noted.
- The meeting noted that the Bank had confirmed with the Irish banks that they had no shortage of collateral eligible for the ECB tenders. Accordingly, there was no reason to anticipate any requirement for emergency liquidity assistance.

CB00584

Pre-budget letters: 2007

- The draft pre-budget letter to the Minister of Finance included an additional paragraph regarding the recent financial crisis:

> "*The forecasts for the year ahead are based on the premise that there will be limited effects from possible domestic or external shocks to the economy. In terms of the external environment, international conditions have been favourable reflecting robust growth in Ireland's main trading partners. It is too early to gauge the full impact on the real economy of the current uncertainties in financial markets, nevertheless the risk of a downturn in the international environment must be considered. While the direct impact on the euro area may be limited, there is scope for more of an effect in the US, thereby increasing the downside risks to global growth*."

- House price inflation changes are reflected:

> "*Over the past year, there have been some important favourable developments in the domestic economy - in particular, the large increases in house prices that were apparent up to last Autumn are no longer evident. The levelling off and subsequent moderate decline in prices reflects a softening in demand due to higher interest rates. This development in house prices has been warranted in the light of already high price levels and the need for borrowing levels to fall back to more sustainable rates of increase*."
>
> "*There is a risk, however, that an unduly large downturn in the housing market*

and the construction sector in general could have serious ramifications for the overall General Government position given the importance of property related tax revenues.

"*In light of this and your recent statements, it would be appropriate that the rate of increase in current spending next year is kept in line with nominal GDP growth, a point that was also emphasised by the IMF in its recent Article IV report on Ireland*."

"*Over the past number of years, the growth in the property market has resulted in substantial windfall gains for the Exchequer, most of which appear to have been saved, which was prudent. This permitted a sufficient buffer in the public finances to be in place to cope with a more challenging economic environment. In the current climate, this buffer needs to be maintained, which would imply aiming for a small surplus in the public finances again in 2008. Limiting the growth of current spending would also enable continued development of the country's infrastructure to take place through the National Development Plan*."

CB00684

Six-monthly survey of business sentiment: 2007

- The survey showed a clear deterioration of sentiment:

"*Of the more important results, businesses were generally much more pessimistic with regard to the outlook for the Irish economy. 63 per cent of respondents felt the outlook for the Irish economy was unfavourable, compared to just 23 per cent in the March Survey*".

- Housing output was set to slow more rapidly than previously expected.
- Data from the Department of the Environment, Heritage and Local Government (DEHLG) indicated that there were approximately 56,000 units added to the domestic housing stock in the first three quarters of this year.
- While output looked set to slow towards the end of this year, the Bank was still expecting somewhere in the region of 75,000 completions this year.

- Very few developers, it was suggested by a major Dublin-based construction firm, had actually started any new developments in the last number of months.
- It was suggested that there were at present over 40,000 housing units unsold, with very little movement in the market.
- Some fall in overall house prices next year in the region of 10 per cent was expected. Some regions, however, would possibly experience greater falls than this.

CB00602

Gníomhaireacht Bainistíochta an Chisteáin Náisiúnta
National Treasury Management Agency

8 September 2011

Mr. Michael Noonan, T.D.
Minister for Finance
Government Buildings
Upper Merrion Street
Dublin 2.

Dear Minister,

You asked me to investigate possible solutions to mitigate the future budgetary impact of the Promissory Notes issued to Anglo Irish Bank, Irish Nationwide and EBS.

Please find attached a brief note summarising our findings.

We have identified one option (Option 4) which has the potential to provide real economic benefits for the Exchequer as well as to mitigate the future budgetary impact of the Notes. This would involve the State redeeming the Promissory Notes by settling them in full with cash funded by additional borrowing from the EFSF.

Such a solution would require access to a facility similar to the stabilisation tools referred to in the Heads of State/Government statement in July which proposed to allow the EFSF/ESM to finance the recapitalisation of financial institutions through loans to governments.

The additional borrowing would be in addition to the €85 billion programme agreed with the EU/IMF.

I would be happy for my officials to investigate this option in more detail, in co-operation with your Department, if you so require.

Yours sincerely,

John C. Corrigan

John C. Corrigan
Chief Executive

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Gníomhaireacht Bainistíochta an Chisteáin Náisiúnta
National Treasury Management Agency

Possible Mitigants to Future Budgetary Impact of Promissory Notes

Introduction

This paper identifies possible solutions to mitigate the impact of the end of the 'interest holiday' that applies, for 2011/2012, to the Promissory Notes issued to Anglo Irish, Irish Nationwide and EBS.

Background/Relevant Facts

The Exchequer issued Promissory Notes totalling €30.85bn (Anglo €25.3bn, INBS €5.3bn, EBS €0.25bn), starting in 2010 (for simplicity hereafter the paper refers to the Anglo Promissory Notes).

The Anglo Promissory Notes carry a series of coupons (as they were issued at different times and were benchmarked to the relevant Irish bond at the time of issue) averaging 5.7% and with a maturity of approximately 13 years, depending on assumptions.

The current structure – whereby the Anglo capital was 'financed' using Promissory Notes – conveys a number of benefits on the Exchequer:

- the Notes include an "interest holiday" which reduces the reported deficit in 2011 and 2012. This treatment will no longer be allowed *prospectively* under proposed Eurostat rules. Indeed if the existing structure is altered in any way (including cancellation and replacement with another debt instrument), Eurostat may retrospectively change the accounting treatment of the interest rate holiday, thus worsening the reported deficits. **The downside to the interest holiday is that, from 2013, the General Government Balance will record a higher coupon (averaging 8.66%[1]) on the Promissory Notes to compensate for the initial interest holiday, thus adversely affecting the budgetary position from 2013 onwards.**

- the Notes are currently carried at amortised acquired value in Anglo's accounts. Any change to the terms of the Notes (e.g., a reduction in the interest coupon) would require them to be restated at fair value (a restatement at current yields would reduce their value by c. €3.4bn). A material impairment would likely directly affect the capital needs of Anglo.

- the Central Bank of Ireland accepts the Promissory Notes as collateral for ELA purposes (However, its stated preference is for the Promissory Notes to be settled for cash).

It is generally accepted that Ireland has dealt comprehensively with its banking issues and has moved on to resolving the fiscal problem. Any solutions that require the State to provide additional capital for Anglo would reopen the banking/Anglo debate[2] with a potential adverse impact on Irish bond yields.

Summary Findings

Four potential options to address the issue were considered. These options are as follows:

1. ***Agree a further concession with Eurostat that would allow a continuation of the interest holiday for the Promissory Notes.*** This possibility has been discounted as it seems clear that Eurostat would refuse any further concession[3]. As noted above Eurostat has closed the existing concession and any such move could actually endanger the existing one.

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2. ***Reduce the interest rate on the Notes*** – paying a lower coupon to Anglo would reduce the deficit and, over time, the General Government Debt. However, it would also result in a very significant impairment of the Notes in Anglo's books, resulting in a requirement for additional capital for Anglo. We estimate that a reduction in the interest rate on the Promissory Notes to 2.7% would cause an impairment of c. €5.2bn in Anglo's accounts. This option also significantly increases the risk of the retrospective and prospective cancellation of the current interest holiday concession.

3. ***Replace the Notes with Irish Government Bonds*** – this structure has been suggested by the ECB (as a preference to Promissory Notes). However the conversion of the Notes to Government bonds would be highly disadvantageous in current market conditions and would increase the Exchequer's debt service costs (because the replacement bonds, if issued at par, would carry a coupon of close to 9% at current rates), worsen the deficit and therefore increase Exchequer debt over time (Anglo may benefit from the higher coupon on these funds but that would not be a certainty and would not materialise for several years). This option also increases the risk of the retrospective and prospective cancellation of the current interest holiday concession.

4. ***Redeem the Notes in full with cash funded by the EFSF*** – Under this scenario, Ireland would source a new loan (as an addition to the current €85bn EU/IMF commitment) from the EFSF at a low interest rate (say 3.5%). It would use these funds to replace the Promissory Notes (at par, including rolled up interest). Anglo would therefore no longer need ELA funding for an equivalent amount and would record no related impairment. However, Anglo would no longer have the benefit of the interest differential between the Promissory Notes and ELA funding, which could affect its capital requirement over time.

   This option would have the benefit of drawing a line under the Anglo issue and, depending on the cost of funding, would result in improvements for the Exchequer in the total recorded debt and the deficit over time. *For example, if the new EFSF loan rate was 3.5%, Ireland's debt service costs would factor in that rate on the new debt instead of a 8.66% rate that would otherwise be recorded on the Promissory Notes from the start of 2013. The cumulative effect of the cheaper funding would be to reduce the Exchequer debt from the baseline forecast by around €10 billion by 2022. The disadvantages include (a) the risk that the interest holiday on the Promissory Notes would be retrospectively cancelled (unless Eurostat can be persuaded otherwise – this could be possible given the potential for the ECB to like this solution), (b) the fact* that the Promissory Notes would be replaced by "hard debt" (albeit at a concessionary rate) and (c) that the extra funding could be construed as a "second bailout".

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[1] Per Department of Finance

[2] In all cases considered, the underlying assumption is the continuing Eurostat classification of Anglo as outside the General Government sector. However it is worth noting that a change to this classification remains a risk. A change to the Promissory Notes could be interpreted as an action by Government which could jeopardise the current Eurostat classification of Anglo.

[3] While we have a clear view on the likely official response by Eurostat to the options set out herein, it is possible that Eurostat could be persuaded, by other European entities, to take a different approach.

Mr. Tom O'Connell: Yes.

Deputy Eoghan Murphy: So when the board made decisions, when it agreed editorial or financial stability reports, when it drafted pre-budget letters, was it making those decisions with the full information?

Mr. Tom O'Connell: Well, those guys were pretty smart, you know. Some of them were in the property sector themselves ... there were businesspeople and others. Had they got the full information? I'm not sure, but, I mean, the drafts, or papers if you like, were filtered through to the board and it was up to the top people in the Central Bank to decide what went or what didn't go, you know.

Deputy Eoghan Murphy: Was it your contention that key facts were intentionally kept from the board of the Central Bank?

Mr. Tom O'Connell: Well, I thought ... I mean, that point about the zoning was an important point, I mean, it's not a ... it's not an issue where there's any impropriety involved or anything like that, in my view, but it's just a common sense economic point that housing supply had to increase and in order to do that you needed more zoned land.

Deputy Eoghan Murphy: And what about then memos that you would have written about reining in lending to the property sector, which you referenced in your opening statement, by imposing credit ceilings? And the memo came back with the words, "That is out of the question", added to the memo. Why did that happen do you think, and was that information brought to the board?

Mr. Tom O'Connell: No, that would have ... that was a note that went to the Governor and yes, ... as I said ... the Governor initially had said, "We'll have to consider bringing this to the board ... this issue to the board, as to whether we restrict the banks in their lending", but the point you mention, "That is out of the question", seems to have overridden that, so that item would not have gone to the board, I think, by definition.

Deputy Eoghan Murphy: And just to clarify again, would the board have been aware of that model that was in the first draft of the financial stability report of 2007 on overvaluations of house prices, Irish property prices, that was then dropped out? They wouldn't have been aware of that?

Mr. Tom O'Connell: No, they would not have known in my view.

Deputy Eoghan Murphy: Okay, so that was also kept from them. When it came to then the drafting of the pre-budget letters, just, these letters that went, were you involved in the drafting, the initial drafting of these?

Mr. Tom O'Connell: Yes, I would have been. I would have overseen it or put some pointers to the chaps who might draw it up, you know.

Deputy Eoghan Murphy: But you wouldn't be involved in final sign-off of those?

Mr. Tom O'Connell: Well, the Governor would have the final say on that, you know. For example, if he didn't like the tone of the draft that was sent to him, he would alter it. He'd come back to us and, yes, he had the final say. Yes.

Deputy Eoghan Murphy: Did the Governor or the board have the final say on the pre-

budget letters?

Mr. Tom O'Connell: The Governor would generally show it to the board, so they would have an input into it in my ... yes.

Deputy Eoghan Murphy: Okay, so would those same vested interests, those same things that were happening that we have just discussed about, would they have also been in play with the submission or the drafting of the pre-budget letters in terms of information being kept from the board?

Mr. Tom O'Connell: Well, I don't think that would have arisen with the pre-budget letter. You know, most things would have been on the table. Now, I can recollect in the past though, having said that, that, you know, from the economics department we might have suggested maybe some tax change or whatever, but that would typically have been not ... that wouldn't run because the view in the bank was that taxation was a matter for Government and we don't sort of suggest that they tax X and subsidise Y, you know. So they would be, sort of, general economic issues, talking about the stance of upcoming fiscal policy in the budget recommendation, maybe bank lending property prices would have figured quite strongly, I think, too, yes.

Deputy Eoghan Murphy: Okay. So that's an example of information not going to the board, but not because of a conflict of interest or a potential one or an intermediary stepping in the way but because it wasn't what the Central Bank did. Is that correct? You didn't give advice on taxation issues. Is that what you said?

Mr. Tom O'Connell: No, no, no. Yes ... I think ... I can recollect way out back in the past we probably did, you know. We put something in about maybe something should be taxed, let's say for environmental reasons or something like that. But the view was that it's not for us to say what taxes should go up or taxes down, it's really for Government, you know.

Deputy Eoghan Murphy: And did you ever disagree yourself with any of the pre-budget letters that were sent to the Minister between 2002 and 2008?

Mr. Tom O'Connell: The ... no, I think ... I think I would have been in general agreement with those, you know, because we would have drafted the approach and the approach generally wouldn't have been massively altered by the Governor or the board for the most part.

Deputy Eoghan Murphy: And did you ever write to the board yourself expressing concern about information being kept from them by the person your reported to?

Mr. Tom O'Connell: No, I didn't, no.

Deputy Eoghan Murphy: And then when we come to the 2004 pre-budget letter, it's noted by the board, after the budget, that the advice from the Central Bank was not fully adhered to. In that scenario, what does the Central Bank do? Does it write a post-budget letter? Does it note this in its financial stability report?

Mr. Tom O'Connell: No, I mean, I think the view is that ... the bank or the Governor is giving advice to the Government, the best advice as he sees it, and the Government is the final arbiter in these things, you know. They can decide to ... not to accept that advice. I mean, it would be fairly common, you know. The Bank of England might be recommending to the British Government the same thing or the Fed in the States, you know, it would be fairly common.

Chairman: I need you wrap up and I'll bring in-----

Deputy Eoghan Murphy: And my final question, the failure to pursue post-budget announcement what hadn't been adopted by the Central Bank pre-budget. Did that have anything to do with the membership of the board of the Central Bank, or vested interests, as you describe them, operating within the bank?

Mr. Tom O'Connell: Well, I can only surmise about that. You know, a lot of people on the board had a strong political affiliations, as you are probably aware. I have ... I mean, it'd be logical for them to put their preferences to their political friends, I suppose, from time to time-----

Chairman: Sorry, I'm not even going to go there. I'm just going to wrap that up. Senator MacSharry, please.

Senator Marc MacSharry: Thanks and welcome, Mr. O'Connell. Just to get through a few ... the mandatory pieces first. Was there any interaction with the banking supervisory team on macroeconomic or financial aspects, for example, on the strong credit growth in the years preceding the crisis?

Mr. Tom O'Connell: Well, there certainly would have been ... as part of the ... procedure for processing the stability report. In fact ... yes, maybe you're, sort of, asking about, you know, the interaction with the regulator, or between the bank and the regulator, and there would have been quite a lot of fora there. You had the memorandum of understanding between the bank and regulator for starters. Then you had the ... the Governor used to have a Monday morning meeting, you know, dealing with current issues and so on, and we'd all be there together. You had the financial stability committee itself, of course, which dealt with things. The regulator and the bank would have been on that. And, of course, we were on the same floor, so we'd bump into one another quite a few times a day. But having said that, I mean, to take one example I remember when the Seán Quinn thing burst, you know, I wouldn't have had any-----

Chairman: Mr. O'Connell, you were in the Central Bank, I think, in 1970 until 2010. By my recollection that's 40 years. Now you probably have a better understanding than any of us inside in this room as to what the obligations of section 33AK actually are. If you want to waive them, inform us that you want to do so and I'll try and guide you but I would be advising you in that regard, okay?

Mr. Tom O'Connell: No, sorry, Chairman, no, I was taking that as an example. When the problem thing arose ... I wouldn't have interacted with my financial regulatory colleagues on the same floor about that but I think I mentioned maybe to one of the guys at the water fountain on one occasion "This is an issue for you", and they'd say "Yes, it is an issue", so you know we wouldn't be going into detail on it, no.

Senator Marc MacSharry: Okay, apart from water fountain interactions, was there a structural or formal interaction between your department and the banking supervisory team in a variety of issues, but you specifically said the stability report?

Mr. Tom O'Connell: The financial stability committee would have been the forum, I suppose, where the interaction was greater-----

Senator Marc MacSharry: Were you on that and was there-----

Mr. Tom O'Connell: Yes I was, yes, and there were regulatory people there too.

Senator Marc MacSharry: That's grand, so there was interaction. That's good. And it

STRENGTHENING THE CAPACITY OF THE DEPARTMENT OF FINANCE

REPORT OF THE INDEPENDENT REVIEW PANEL

December 2010

EXECUTIVE SUMMARY

1. The Panel was established by Minister for Finance Brian Lenihan on 10 September, 2010, to examine the Department of Finance's performance over the last ten years and advise how the Department might adapt to meet the challenges of the future. Ireland's economic challenges are substantial, and have become more starkly defined over the three month period of our review.

2. We had enormous support conducting our review. We met a large number of people from the political system, officials from the Department, individuals from the broader Public Sector and those with an interest in, and interaction with, the Department. We invited and received very useful submissions from the public. We enjoyed complete access to departmental personnel and records. We were impressed with the enthusiasm of the Secretary General and the Department for this exercise, at a time of unprecedented pressure.

3. The Irish economy was transformed in recent decades. A period of very strong growth in the 1990s was sustained by enhanced competitiveness and export growth. Pending membership of the single currency spurred inward investment. Despite predictions to the contrary, the Irish economy continued to grow substantially after 2000. However, the dynamic fundamentally changed. Exports no longer contributed significantly to growth, which was now driven by domestic developments, notably investment in building. Participation in EMU left interest rates too low for Irish circumstances. This fuelled the property boom as did financial market competition and interbank borrowing from Europe. Meanwhile, Irish competitiveness had deteriorated very significantly. The property bubble began to collapse from 2007 and the fallout was exacerbated by a significant deterioration in the external environment. The economic and fiscal challenge was, of course, severely aggravated by the failure of the Irish banking system.

4. The Government initiated two scoping reviews of the origins of the current crisis. Based on these reviews, the Government launched a Statutory Commission of Investigation into the Banking Sector, chaired by Mr Peter Nyberg. The Panel has been deliberate in ensuring that we did not overlap with the mandate of this statutory review.

5. To provide a focus for our review of departmental advice over the last ten years we examined three key questions:

- How appropriate was the Department's advice on the risk of pro-cyclical fiscal policy?
- Was the Department aware of the risks of overheating in the property sector and did it provide advice appropriate to the circumstances?
- Did the Department provide sufficient advice on the vulnerability of the tax system to an economic downturn?

6. The Panel reviewed in detail the annual June Memoranda to Cabinet on Budget Strategy. Generally speaking, we found that advice prepared by the Department for Cabinet did provide clear warnings on the risks of pro-cyclical fiscal action. These views were signed-off by the Finance Ministers of the day who would submit the Memoranda to Cabinet. The Department's advice was more direct and comprehensive than concerns expressed by others in Ireland, or by international agencies. With very few exceptions, however the quantum of spending and tax relief outlined in December Budgets was very substantially above that advocated by the Department and Minister in June.

7. We see three key reasons for this failure of fiscal policy. First, there were extraordinary expectations of Government in Ireland to create spending and tax initiatives to share the fruits of recent economic gains. These pressures were reflected in the political debate of the day where all political parties were eager to meet public expectations for more and better services. As well, the Irish economy was regarded by most as a model. The EU fiscal rules, the Stability and Growth Pact, were respected, debt fell and spending appeared to be well below EU levels. The underlying dangers were either missed or ignored.

8. Second, the Government's Budget process was completely overwhelmed by two dominant processes - Programmes for Government and the Social Partnership process. We recommend major changes to the budgetary process that would enhance ministerial accountability to Parliament, expand the release of detailed departmental analysis for consultation well before Budget time and provide oversight by some form of Fiscal Council.

9. Third, the Department of Finance should have done more to avoid this outcome. It did provide warnings on pro-cyclical fiscal policy and expressed concern about the risks of an overheated construction sector. However, it should have adapted its advice in tone and urgency after a number of years of fiscal complacency. It should have been more sensitive to and provided specific advice on broader macroeconomic risks. And it should have shown more initiative in making these points and in its advice on the construction sector, and tax policy generally.

10. We provide recommendations to formalise Department's records of Budget advice, to strengthen the rigour of the Department's policy advice and expand resources for tax policy and medium term economic planning.

11. The Panel recommends formalising in legislation the Department's accountability for assessing systemic macro-economy risks.

12. Turning to the issues arising from the structure and staffing of the Department; based upon our analysis, submissions from others, and consistent with views of Finance employees and managers we met, the Department:

- does not have critical mass in areas where technical economic skills are required;
- has too many generalists in positions requiring technical economic and other skills;
- is more numbers driven, than strategic;
- does not have sufficient engagement with the broader economic community in Ireland;
- often operates in silos, with limited information sharing;
- is poorly structured in a number of areas, including at the senior management level; and
- is poor on Human Resources Management.

13. We have been direct in our analysis and advice, but do not accept the notion that the Department is not fit for purpose. It has worked hard in response to the banking and economic crisis and must now apply the same determination to remake itself in the light of our observations in this report and the major challenges confronting Ireland.

14. The Panel recommends that the Department sharpen its focus on core business and then substantially strengthen its capacity to manage that core business. The Public Service Management and Development Division should be managed as a separate entity, as either a separate Department, or reporting directly to the Minister of State for Public Service Modernisation. The Minister and the Department of Finance should retain authority over the overall wage bill, negotiating mandates for new collective bargaining processes and manage a single window with other Departments to control public spending.

15. This change should help focus effort on the extraordinary opportunity provided by the Croke Park Agreement to modernise the capacity of the Public Service. We recommend two other processes to help – a fulltime Task Force from across Government to include individuals from the leading Departments and a Private Sector Advisory Board to help drive the process.

16. The Panel believes that the Sectoral Policy Division is a core function of the Department especially given the need to implement the economic recovery plan and the requirement for medium-term economic planning. The Department would be at risk of losing critical mass with any transfer of core functions.

17. To strengthen the remaining core Finance structure, we offer a set of recommendations to modernise management, reform existing organisation structures and add substantially more people with technical economic and other skills.

18. Working structures of the Department are less than optimal. We recommend removing a level of management from line management responsibilities. We also offer recommendations to reform working level structures and increase the effectiveness of the Department's Management Advisory Committee, including the creation of a Corporate Secretariat that would help enhance internal communications and outreach to the public.

19. On people, the Department needs to increase substantially its numbers of economists trained to Masters level or higher and add other technical capacity, especially accounting, banking and financial markets expertise. Over the next two years the Department should

double its number of economists trained to Masters Level. It should organise itself to engage more University recruits at that level every year.

20. On processes, the Department should commit to modernising the HR Management function. It should engage a professional Human Resources expert from outside Government to help develop HR systems. This should include performance management where dramatic improvements are necessary.

21. The Secretary General of Finance should lead this management renewal, presenting a change management plan to employees and reporting on progress in an annual accountability session with staff.

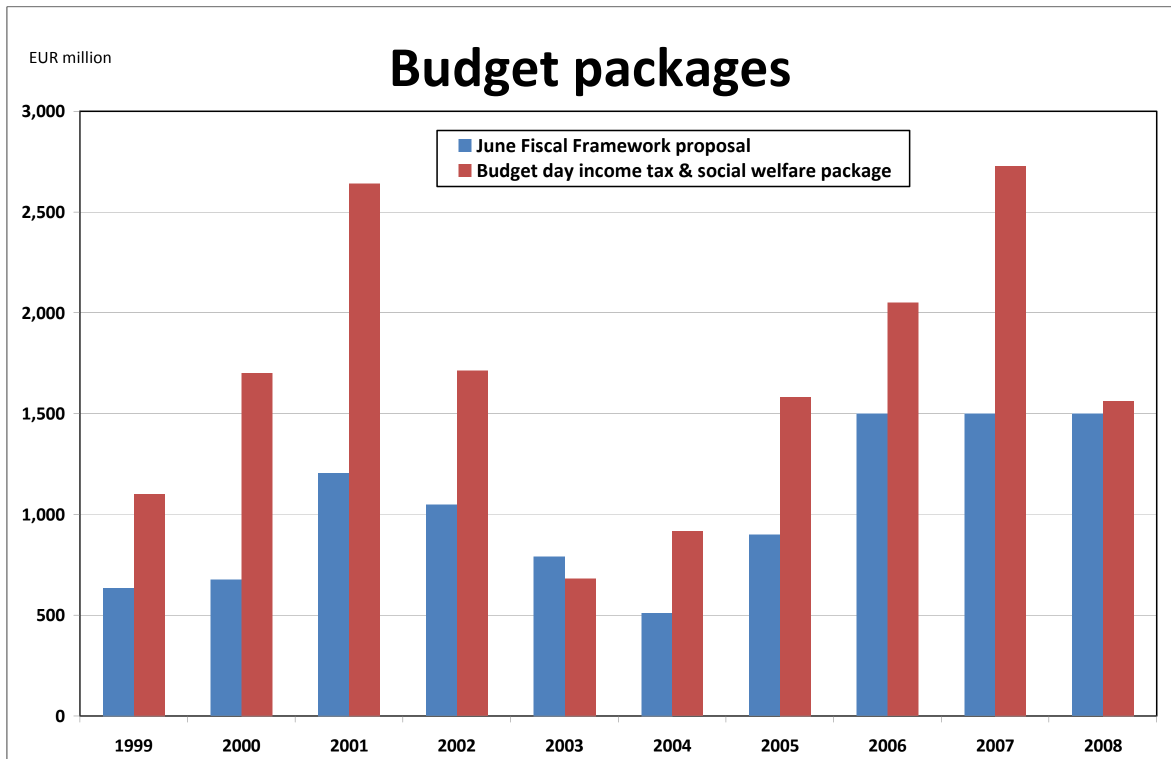
3.2 Pro-cyclical fiscal policy

3.2.1 The Panel reviewed international assessments of the risks of pro-cyclicality. A summary of commentary by the EC, OECD and IMF is at Appendix 6. These institutions frequently pointed to the risks of overheating prices and wages in Ireland, thereby decreasing its international competitiveness. Signals of overheating were especially loud in the early 2000s, when the Council gave an official warning to Ireland under article 99.4 of the Treaty, but became more muted as the global (and Irish) economy recovered from the burst of the ICT bubble. Nevertheless throughout the period, and especially from 2004 to 2008, these criticisms were leavened by favourable comment and even praise for Irish policy.

3.2.2 To review the Department's advice on the risk of pro-cyclical fiscal policy, the Panel began with a review of budgetary advice over the last ten years. The current budgetary process includes a number of stages. The Department consults other Departments, assesses the state of the economy, and works with the Minister to prepare a Memorandum to Cabinet on Budget Strategy in June of each year. That Memorandum projects economic and fiscal circumstances and outlines a quantum of spending and tax expenditure actions that are appropriate to the circumstances. Work to detail specific actions following this Cabinet discussion continues to the autumn. Since 2006, a Pre-Budget Outlook is usually issued in October to guide public dialogue up to the delivery of the Budget in early December. Significantly, final payments for previous year corporation tax and income tax payments by the self-employed yield critical information on the Government's current revenue position, well after the October Outlook and the initial Cabinet determination of Budget strategy in June.

3.2.3 The Panel reviewed in detail the annual June Memoranda to Cabinet on Budget Strategy. Generally speaking, we found that advice prepared by the Department for Cabinet did provide clear warnings on the risks of pro-cyclical fiscal action. These views were signed-off by the Finance Ministers of the day who would submit the Memoranda to Cabinet. Department officials do not, of course, participate in Cabinet discussion. This advice was more direct and comprehensive than concerns expressed by others in Ireland, or by international agencies.

3.2.4 With very few exceptions, however the quantum of spending and tax relief outlined in December Budgets was very substantially above that advocated by the Department and Minister in June. This can be seen in the chart following:



3.2.5 The differences between the position advocated in June and the outcome in December are stark but must be seen in the proper context. The Panel is conscious that the June quantum was seen as a starting point in the budgetary process. We present the chart simply to demonstrate that the June framework around which the Department's fiscal guidance was given was consistently and substantially exceeded. We examined why relatively prudent fiscal advice in June was systematically ignored in the Budget process. A number of factors contributed to this failure.

3.2.6 As noted earlier, very strong economic and fiscal performance in the 1990s created an extraordinary sense of optimism in Ireland. This fuelled enormous expectations of Government to create spending and tax initiatives to share the fruits of recent economic gains, even as the country's overall competitiveness degenerated substantially and revenues became unsustainable. These pressures were reflected in the political debate of the day where all political parties were eager to meet public expectations for more and better services. Consistently higher growth and revenue outcomes late in the Budget cycle further

inflated expectations. Finally, the public and policy makers were insufficiently sensitive to the effects of extraordinarily expansive monetary conditions at the time, and to the fact that fiscal policy was the key potential counterbalance to this pressure.

3.2.7 Beyond a general sense of optimism, we review below two other aspects that contributed to this massive, sustained slippage from the June Fiscal Plans. First, a very poor budgetary process obscured ministerial and Government accountability to Parliament, and was overwhelmed by other spending processes – Programmes for Government and Social Partnership. Second, while departmental advice in June was generally appropriate, we have a number of observations as to how departmental advice could have been more effective over the entire budgetary cycle. We review these factors below.

3.3 Budgetary and other processes

3.3.1 All parties establish a platform going into an election. A vital part of coalition Government is the preparation of a joint Programme for Government by governing coalition partners. Such agreements are core to the political stability of the governing coalition and often include very specific spending and tax expenditure commitments. These initiatives are presented as given, without a full economic or fiscal analysis by the Department of Finance.

3.3.2 The process leaves the Department to debate the pace of delivery of new spending and tax initiatives but not the Government's commitment to these important fiscal matters. The Department could, and did, argue for reallocation of existing spending to offset new commitments in a Programme for Government. But this proved increasingly difficult, and ineffective, given the magnitude of Programme for Government commitments and the availability of resources. Included below is an excerpt from the 2002 Programme for Government that illustrates the specificity of these commitments.

The parties remain committed to the achievement of the taxation objectives set out in Action Programme for the Millennium. Over the next five years our priorities with regard to personal taxation will be:

– to achieve a position where all those on the national minimum wage are removed from the tax net, and
- to ensure that 80% of all earners pay tax only at the standard rate.
– to use the potential of the tax credit system to effectively target changes and to pursue further improvements in the income tax regime if economic resources permit.

• We will complete the reduction of the standard rate of corporation tax to 12.5% in 2003.
• We will increase Capital Gains Tax exemption limits.
• We will examine the tax treatment of share options.
• We will keep down taxes on work in order to ensure the competitiveness of the Irish economy and to maintain full employment.
• We will vigorously pursue actions to ensure that that everyone is tax compliant.

3.3.3 The 2002 Programme for Government, like others, undertook to achieve these changes while promoting "low inflation" and "responsible fiscal policies" and maintaining the "public finances in a healthy condition". However, the dominant impact of Programmes for Government was to create a ready list of politically driven spending and tax initiatives to insert into Budgets, including to the extent of any last minute revenue availability.

3.3.4 The Social Partnership process was also a major driver of spending. Initiated in the 1980s, this process led to a number of national social and economic agreements between 1987 and 2009, which included pay settlements in the private and public sectors. The 1987 agreement and agreements in the 1990s tended to trade-off wage moderation for lower personal tax rates, with the effect of increasing take home pay. In the negotiations leading up to these agreements, the general levels of increases were effectively settled between the private sector employers and trade unions, with the increases applying by extension to the public service.

3.3.5 This process was extremely important to Ireland emerging as an economic growth leader in Europe. Wage costs were set at competitive levels. The process also created a climate of labour harmony that further enhanced the investment climate.

3.3.6 However, the process helped to generate profoundly different outcomes after 2000. An over-heated economy generated labour shortages and high wage demands. These pressures overwhelmed private sector wage negotiations and, through the Partnership Process, also inflated public sector outcomes. Such demands were difficult to deny given

the burgeoning revenues generated by an over-heated economy. Economic overheating, along with the Social Partnership Process, led to a major deterioration in competitiveness in the Private Sector and to very high Public Service wages, especially relative to international partners. Primary School teacher salaries, for example, rose from seventh of ten countries in the OECD comparator group in 2002 to third, behind only Germany and Switzerland by 2008.

3.3.7 As the representative of the Public Service employers, the Department of Finance had an important input to the Partnership Process, and consistently warned of growing threats to competitiveness. But it did not drive the process, and was reluctant to oppose packages that included outcomes that retained labour peace for the economy as a whole.

3.3.8 Over the ten year period of review, the Programme for Government and Social Partnership Processes helped overwhelm the Budget process. Instead of providing an appropriate fiscal framework for prioritisation of competing demands on the Government's overall agenda, the Budget essentially paid the bills for these dominant processes. Relatively clear advice to Cabinet in June on the risks of excessive spending and tax reductions was lost by the time of December Budgets.

3.3.9 Spending pressures of this magnitude could have been resisted even within the established Budget process. However, the chance of success would be substantially enhanced by modernizing the budgetary process to protect the Government's annual fiscal framework.

3.3.10 In the current budgetary process, the period for public dialogue on economic and fiscal challenges facing the economy is far too short. Departmental advice on the economic outlook and sectoral challenges, for example, should be subject to more public and external scrutiny before Budgets are finalised. The process must also support a more rigorous commitment to the planned quantum of fiscal action. The objective of a renewed budgetary process should be to enhance ministerial accountability to Parliament, and the public by:

- creating a meaningful consultation period, and seeking broad feedback on the Government's fiscal plan,
- releasing more departmental analysis to inform public debate, and

- providing for third party validation of departmental analysis and the Government's fiscal plan through some form of Fiscal Council.

3.3.11 *Recommendations:*

1) *After Cabinet review of Budget strategy in June, and consistent with its April submission to the European Commission, the Government should release for public and parliamentary review:*

   - *the Department's economic and fiscal forecast,*
   - *the Department's assessment of the economic and fiscal risks to this outlook,*
   - *related sectoral analysis by the Department and*
   - *the Government's proposed quantum for fiscal action in new spending and tax expenditures.*

   The Minister and the Department should consult widely on this framework, particularly with the relevant Oireachtas Committee.

2) *Departments would not seek spending enhancements beyond the spring consultations leading to the Budget review at Cabinet.*
3) *To the extent that November tax results surprised to the upside, such revenue should be used for debt reduction, not new spending or tax relief.*
4) *The Panel supports the establishment of a Fiscal Council to review and publish commentary on the Department's analysis and the Government's proposed quantum for fiscal action. The Panel believes that such a Fiscal Council must be independent of Government, have qualified membership, a straight forward role and the ability to report in a timely manner. For example, following a June release of the Government's fiscal plan, the Fiscal Council could review:*

   - *the Department's economic and fiscal outlook,*
   - *the Department's risk assessment,*
   - *whether the proposed fiscal framework, including provision for new Government budgetary action, entails acceptable risks for the economy.*

5) *To the extent the December Budget exceeds the quantum of action identified in June, the Fiscal Council should reassess the risks of these further actions for the economy.*
6) *The Fiscal Council could also usefully assess the impact of future Social Partnership wage and fiscal provisions on Ireland's economic competitiveness.*

3.4 Economic and Fiscal Forecasting

3.4.1 The Department's economic and fiscal forecast is critical to the budgetary process. It helps to guide choices on economic and fiscal policy. The Panel's terms of reference specifically directed us to review the Department's record on economic and fiscal forecasting. The Department works closely, but informally, with colleagues in the Central Bank, ESRI and Revenue Commissioners to prepare its economic and fiscal forecasts. All those who discussed forecasting with the Panel judged the Department's work to be as good as any other institution making forecasts of the Irish economy. However, the recent past also demonstrates that it is extremely difficult to project "turning points" particularly in a rapidly growing economy.

3.4.2 More critical comments were made on the issue of whether the Department and Government could not have been more active in publishing alternative forecast scenarios. Given the record of advice and concern on pro-cyclical fiscal policy in the Department, a forecast scenario of a major correction could have been very informative, in retrospect. An improved budgetary process overall would also strengthen the forecasting function. The Panel believes that this function would be further strengthened by a more robust engagement with outside economists.

3.4.3 *Recommendations:*

7) *Forecasts in Budget Memoranda to Cabinet and for public consultations should include well articulated scenarios of alternative outcomes, consistent with the Department's risk analysis.*
8) *In addition, the Department should provide a public work-shop, with private sector and academic interests, once a year so that the assessment of the economic and fiscal challenges can be debated before the Department finalises its forecasts.*

3.8.4 *Recommendation:*

14) *The Department should include sectoral assessments in its annual economic analysis and forecast that is released for public consultation.*

3.9 Tax Policy Advice

3.9.1 The panel reviewed whether the Department adequately advised on the vulnerability of the tax system to a downturn. First, the Department was very clear on the risks to the Exchequer of a downturn in the construction sector, providing specific estimates of the fiscal risks, and clear advice on the dangers of relying on related tax revenues.

3.9.2 However, there was no analysis or advice on the broader risk to the tax system from a more general downturn in economic activity from levels created in part by pro-cyclical fiscal policy. This lack of policy initiative is again disappointing, given the very active tax agenda of the Government over the last ten years. In fairness, the Government's tax agenda was effectively defined at the political level, as part of the Programme for Government. For example, Programmes for Government limited the income tax base by removing minimum wage earners from the tax net and committing to keep 80 per cent of taxpayers at the lowest rate of taxes. These were effective political messages for the electorate, but not good tax policy. Once established as Government policy, there was no market for departmental advice on the suitability of such commitments. But such analysis should have been provided and communicated forcefully to the Minister for Finance and the Government.

3.9.3 The result was the narrowing of the tax-base to an unsustainable degree and commitment to major tax expenditures. The narrowness of the tax base and the complexity of the tax system suggest to the Panel that there is need for a review of the entire system.

3.9.4 *Recommendation:*

15) *The Department should substantially increase its analytical capacity in the tax policy area.*
16) *The Department should organise itself to consult with tax and financial experts and prepare advice that is most appropriate to an efficient tax regime for Ireland.*

3.10 Department's Response to the Crisis

3.10.1 The Panel reviewed the Department's support to the Government since the banking crisis broke. The Department played a key role on the banking side by using the Domestic Standing Group to organise a whole of Government assessment of the situation at the early stages of the crisis. The Department also played a lead role in managing the Government's fiscal response to the crisis, including several major policy packages:

- major fiscal action in Budget 2009,
- again in the supplementary 2009 Budget,
- in Budget 2010, and
- in the Public Service Agreement, 2010-2014 (the Croke Park Agreement).

3.10.2 These actions reflect a marked enhancement in leadership from an organisation not called upon to lead for much of the previous decade.

3.10.3 Every party that worked with the Department over this period commented positively on the quality of effort and professionalism displayed during this period of need. At the same time, the extraordinary pace of activity has exposed some major shortcomings in the Department's capacity. When the banking crisis broke, the Department had neither the time nor the resources to conduct in-depth investigation of issues. This reflected shortages of skills in the requisite disciplines and inadequate knowledge of underlying developments in the sector.

3.11 Medium Term Analysis

3.11.1 Any Finance Ministry should have a medium-term economic planning capacity. Economic planning and analysis are specific elements of the Department's statutory functions since the Department of Economic Planning and Development was merged with the Department of Finance in 1980. The Department has developed the *National Recovery Plan 2011-2014* and will monitor its implementation over the coming years.

4.7 Structure

4.7.1 The Department of Finance is unique among Civil Service Departments in that Assistant Secretaries do not report directly to the Secretary General. There is an additional level of management – Second Secretary General[1] - between the Secretary General and the Assistant Secretaries in the Department of Finance. This arrangement blurs accountability, under-utilises the expertise of Assistant Secretaries and helps to inhibit effective internal communications.

4.7.2 It is our view that the existing and future needs of the Department require changes to the roles and responsibilities of the Second Secretary grade. It is simply not possible for the Secretary General to deal with the large number of high-level, pressing issues confronting the Department without this senior level of support. However, removing Second Secretaries from their responsibilities as managers of large Divisions would free them up to play a more strategic support role than is possible at present.

4.7.3 *Recommendations:*

28) *Assistant Secretaries should report directly to the Secretary General of Finance.*
29) *Second Secretaries should cease to have divisional line management responsibilities, but should be able to call upon resources across the Department as and when necessary.*
30) *The Second Secretary currently responsible for Sectoral Policy Division should be designated as Chief Operating Officer for the Department. The function of this post would be to lead the co-ordination across the Department of major issues, for example, to lead the interaction between the Budget and expenditure sides of the Department, and otherwise to help ensure the entire Department is connected to key policy and management issues.*
31) *The Second Secretary post leading the Budget, Tax and Economic Division could focus primarily on the increasingly important role of interacting with the institutions of the European Union and other international institutions.*
32) *The Second Secretary responsible for Financial Services should retain responsibility for this function until such time as the banking crisis is considered to*

[1] One of the positions at the second level is graded as Secretary General, and is in charge of Public Service Management and Development Division.

4.10 Structure at the Working Level

4.10.1 We have recommended that the management role of Assistant Secretaries should be clarified and enhanced. We are also aware that there is a tendency in the Department for work and responsibility to be retained at senior management levels when it could, more appropriately, be delegated. Each Assistant Secretary should look at his/her responsibilities with a view to devolving work to Principals. Principals should also ensure that they have devolved work appropriately to their Assistant Principals.

4.10.2 The Panel also has concerns about the spread of responsibilities at the level of Principal and at the basic work unit in the Department below Principal, i.e. the section led by an Assistant Principal. We noted that, across the Department, the ratio of Principals to Assistant Principals is currently approximately 1:2.5, while the number of Assistant Principals is almost equivalent to the number of Administrative Officers (AOs) and Higher Executive Officers (HEOs) reporting to them. The situation varies in some areas, with some supervisors having more or less than the average. This narrow reporting structure is unlikely to foster horizontal thinking on the part of either Principals or Assistant Principals. Equally, it deprives staff of the benefits of working as part of a wider team. Finally, it could be wasteful of resources. It is our view that this structure should be changed to enhance teamwork and broaden the span of responsibility and supervision at Principal and Assistant Principal levels.

4.10.3 *Recommendation:*

> *38) The Department should examine working level structures and the devolution of responsibilities to ensure the delegation of more responsibilities to middle management levels and to create larger teams throughout the organisation.*

4.11 Enhancing the Department's technical skills

4.11.1 In its cadre of 542 staff, the Department has only 39 economists trained to Masters level or higher. Many of these individuals are public servants of the highest calibre and excellent practitioners of applied economics. Many other staff who have less formal economic training have also distinguished themselves over the period of our review.

However, 39 economists in the Department of Finance is extraordinarily low by international standards. Even excluding the public service cadre of 135 people, this represents less than 10 percent of the total staff complement in the core of Finance. In contrast, 60 percent of the Canadian Department of Finance are economists trained to Masters level or higher; and about 40% of staff in the core areas of the Dutch Finance Ministry are trained to Masters level or higher.

4.11.2 The Department does not need 60 percent of its staff to be economists. But it must make an urgent and sustained effort to boost its number of economists and other skilled staff. Management should define the technical needs of positions and hire the best person for the job whether from within Government or otherwise.

4.11.3 *Recommendations:*

39) *Even in this period of restraint, the Department must find a way to increase substantially the numbers of economists and other staff with relevant technical qualifications.*
40) *The Department should double the number of economists, appointed through open, public competition and trained to Masters level or higher, over the next two years. These appointees should comprise a mix of recent university graduates and experienced individuals and be assigned to positions throughout the organisation. The Department should organise itself to maintain a regular inflow of new university recruits.*
41) *The Department should work to establish a welcoming professional environment for new economists. Economists at Masters level and above should be identified and their numbers reported on annually; a champion for establishing and promoting this "community of interest" should be named.*
42) *The economic seminars by external economists, which were recently introduced by the Secretary General, should be made permanent; the Department should permit the publication of professional economic analyses, by staff in the Department, that are clearly identified as not the views of the Department.*
43) *The Department should expand its complement of skilled staff in other disciplines, especially accounting, analysis, banking and financial markets.*
44) *The Department should immediately seek the secondment of skilled personnel on a two-year rotation from the Central Bank, NTMA, ESRI and other relevant bodies.*

45) The Department should also promote exchange agreements with other Finance Departments internationally.

4.12 Enhanced HR function

4.12.1 Human Resource Management is currently a low priority for the Department of Finance. The importance of this function tends to be crowded out by the daily churn of urgent issues. The consequences of the neglect of this area are evident in a number of ways: insufficient commitment across the Department to performance management, skills shortages in critical areas and reporting structures at senior and middle-management levels that are far from ideal.

4.12.2 If this function is to be enhanced, and to contribute proactively to the essential development of the Department, it must be lead by an appropriately qualified, dynamic HR specialist, ideally with relevant experience in the private sector. The HR specialist would be given a small number of high-level targets to be achieved over a three year period. In order to give the Department more freedom with regard to the contract of the appointee and to stress the results-driven nature of the post, consideration might be given to making the appointment on a short-term contract, initially for three years.

4.12.3 The majority of staff at the Department are well suited to the needs of their position. As in any organization, some are not, and conspicuously underperform. This is a serious morale issue for other employees and a material impediment to departmental performance, particularly in a period of restraint. Performance management is a challenge to deal with in any organization. The Department also currently lacks the tools to deal with the issue, and must substantially upgrade its performance assessment process and practices and establish broader support mechanisms to help managers confront under-performance.

4.12.4 The Department of Finance should become a centre of excellence in the area of performance management and act as an example to other areas of the Public Service in this regard. We are aware that this issue is of concern to employees and the senior management in the Department. We would like to see a clear articulation from top management of the

necessity for a properly-functioning performance management system where issues of under-performance are addressed effectively.

4.12.5 *Recommendations*:

46) *A senior HR specialist should be appointed to the Department initially, at any rate, on a short-term contract. The post would be advertised and preference would be given to an individual who had managed a dynamic HR function in the private sector.*
47) *The Department should reinforce its performance review process and require the identification of under-performance and an individualised plan to deal with problems identified.*
48) *Once each year, the MAC should take a full day to review individual performance in the Department. It should identify, of all supervisors, the top 20% on people management – those who recognise high performance and deal with poor performance. This process should also identify the bottom 20% - those supervisors who are not performing well in this area and those who are not taking a proactive approach to this issue. Plans to address under-performance should be required. A supervisor's performance in "people management" should have a material impact on consideration for promotion.*

4.13 Change Management

4.13.1 Collectively, the recommendations of the Panel represent major change in the Department of Finance. The Panel believes this change agenda will be embraced by the Department and its Secretary General. The Secretary General will need personally to lead this renewal process but will require support.

4.13.2 *Recommendations:*

49) *The Secretary General should present a Change Management Plan to employees and report on progress in an annual accountability session to all staff.*
50) *He should be supported by all managers, by a champion for change management at Assistant Secretary level and by the newly recruited professional HR specialist.*

APPENDIX 6

Summary of International Reports on the Irish Economy

The reports summarised below are from three sources: the European Commission (EC), the IMF and the OECD. This Appendix is structured as follows. First, the conclusions of the EC's recommendations to the Council on the Irish stability programmes from 1999 to 2010 are summarised. Second, the OECD's economic surveys of 2003, 2006 and 2008 (these are published roughly every two and a half years) are summarised. Finally, the Executive Directors' conclusions from the bilateral article IV consultations procedure of the IMF are summarised.

EC Reports

1. EC recommendation to Council of 12 January 1999:
   i. budget projections for 1999-2001 were realistic and in line with the Stability and Growth Pact (SGP);
   ii. the expected decrease of the debt ratio from 60% in 1998 to 43% by 2001 was welcomed;
   iii. the authorities were warned that the favourable economic situation was not without risks, in particular from rising wages and inflationary pressures;
   iv. a tighter fiscal policy would help contain these pressures;
   v. welcomed the planned increase in public investment to meet infrastructural needs and to replace EU structural funds.
2. EC recommendation to Council of 18 January 2000:
   - roughly the same as a year before.
3. EC recommendation to Council of 24 January 2001:
   i. an official warning was given under article 99.4 of the Treaty, as fiscal policies were not in line with the 2000 Broad Economic Policy Guidelines (BEPG);
   ii. the expansionary nature of the 2001 Budget constituted a major risk;
   iii. the direct and indirect tax cuts and very large increases in current and capital expenditure would worsen the overheating problem;
   iv. the fiscal loosening planned for 2001 was inappropriate for an economy operating above potential – GDP was forecast to grow by nearly nine percent.

4. EC recommendation to Council of 30 January 2002:
    i. concerns were expressed that the previous budgetary strategy of maintaining high surpluses and further reducing the debt ratio, which had been endorsed by the Council, were no longer being followed;
    ii. the fiscal targets implied that Ireland could cease to comply with the "close to balance" requirements of the SGP by 2003 but would still avoid breaching the 3 percent of GDP threshold;
    iii. regretted that the new update did not present any plans to introduce a medium-term framework to guide public spending or to improve expenditure control as requested in the BEPGs agreed for 2001;
    iv. noted with satisfaction the broad-based strategy to prepare for ageing population;
    v. warned that recent rates of increase in current and capital spending, motivated by a desire to tackle infrastructural needs and public sector deficiencies, could not be sustained without action on the revenue side.
5. EC recommendation to Council of 30 January 2003:
    i. although the 2002 budget was judged to be expansionary, in the event, policy was expected to be neutral in 2003 as a result of (1) a cut in capital expenditures, (2) a marked reduction in the growth rate of current expenditures and (3) an overall stabilisation of the tax burden;
    ii. the targets in the programme respected the safety margin against breaching the 3% of GDP threshold for the deficit ratio;
    iii. although Ireland was in a relatively good position considering its low debt level and gradual build-up of assets in the National Pensions Reserve Fund, the deficit position envisaged for 2005 did not seem to be ambitious enough.
6. EC recommendation to Council of 28 January 2004:
    i. while there was little or no improvement in the budgetary position between 2004 and 2006, Ireland was on a sustainable path with some long-term risks;
    ii. future age-related spending might become a problem, although the debt ratio was quite low and there was a gradual build-up of assets in the National Pensions Reserve Fund;
    iii. commended the Irish authorities for the extension of multi-annual budgeting system to all capital spending.
7. EC recommendation to Council of 2 February 2005:

i. the macroeconomic scenario appeared plausible;
ii. the budgetary stance seemed to be sufficient to maintain the SGP's medium-term objective of being close to balance or in surplus;
iii. the risks attached to budgetary projections appeared broadly balanced as forecast receipts seemed plausible, contingency provisions were quite high, and Ireland had made encouraging progress in adhering to expenditure targets;
iv. Ireland appeared to be in a relatively favourable position with regard to the long-term sustainability of its public finances with low debt ratios and accumulating reserves in the pension fund;
v. overall, economic policies were in line with 2003-2005 BEPG.

8. EC recommendation to Council of 22 February 2006:
    i. budgetary position was sound and the budgetary strategy provided a good example of fiscal policies in compliance with the SGP;
    ii. the EC invited Ireland to continue to implement measures to address the long-term budgetary implications of an ageing population.
9. EC recommendation of 7 February 2007:
    i. medium-term budgetary position was sound and, provided the fiscal stance in 2007 did not prove to be pro-cyclical, the budgetary strategy provided a good example of fiscal policies conducted in compliance with the SGP;
    ii. it would be prudent to maintain room for manoeuvre against any reversal of the current growth pattern which had been led by strong housing sector developments;
    iii. Ireland was invited to continue to implement measures to improve the long-term sustainability of its public finances.
10. EC recommendation of 19 February 2008:
    i. Ireland was facing several macroeconomic challenges in its transition to a period of lower economic growth (mainly the return to more sustainable activity in the housing sector);
    ii. slowing domestic demand had been accompanied by losses in recent years in export market shares as a result of price competitiveness challenges;
    iii. a notable deterioration of the fiscal position to a deficit over the period 2007-2008 was envisaged;

iv. the risks attached to the budgetary projections were broadly neutral in 2008, but, from 2009 onwards, outcomes could be worse than projected due to insufficient expenditure containment;

v. as the public debt was low, Ireland was at medium risk because of the projected impact of population ageing on pension expenditure;

vi. Ireland was invited to keep firm control over expenditures and to implement further pension reforms to improve long-term sustainability of public finances.

11. EC recommendation to Council of 18 February 2009:

i. following a very sharp deterioration in 2008, the general government deficit would widen further in 2009, to 9.5% of GDP;

ii. measures adopted in response to the economic downturn were welcome and adequate given the high deficit and sharply increasing debt position and were in line with the European Economic Recovery Plan;

iii. a reduction of the deficit was envisaged to below 3% of GDP by 2013, while debt would breach the 60% reference value from 2010;

iv. budgetary outcomes were subject to downside risks mainly due to lack of information on the envisaged consolidation measures after 2009 and the optimistic macroeconomic outlook especially in later years;

v. further risks resulted from measures to support the financial sector (bank guarantees, possibility of further capital injections or nationalisations of banks);

vi. Ireland was invited to (1) limit the widening of the deficit and rigorously implement a substantial broadly-based fiscal consolidation in 2010 and beyond; (2) strengthen the medium-term budgetary framework as well as closely monitor adherence to the budgetary targets; and (3) improve long-term sustainability of public finances by implementing further pension reform measures in addition to pursuing fiscal consolidation.

12. EC recommendation to Council of 22 April 2010:

i. regarded Ireland's response to counter the widening of the government deficit as swift and determined;

ii. General Government Deficit was expected to stabilise in 2010 at 11.6% of GDP and a back-loaded reduction was envisaged to below the 3% of GDP reference value by 2014;

iii. the budgetary outcomes could be worse than targeted mainly due to (1) lack of specifics on post-2010 consolidation efforts (2) the forecast favourable macroeconomic outlook after 2010 and (3) the risk of expenditure overruns in 2010 and beyond to the extent that the still to be spelled out strategy should rely on expenditure restraint;

iv. although the size of the 2010 savings package was broadly in line with the Council recommendation of 2 Dec 2009, it would be important to address the risks identified by spelling out the measures underlying the consolidation strategy and adopting additional measures if growth disappointed or spending slipped;

v. there was a need to regain competitiveness through measures enhancing productivity growth and adequate wage policies, and to support the re- and up-skilling of the newly unemployed to prevent them from turning into long-term unemployed;

vi. further reforms to the pension system were important to improve the long-term sustainability of the public finances;

vii. Ireland was invited to (1) implement rigorously the Budget for 2010 and back up the envisaged consolidation packages for the following years with concrete measures, while standing ready to adopt further consolidation measures should this prove necessary, (2) improve the long-term sustainability of public finances by implementing further pension reform measures, (3) limit risks to the adjustment, strengthen the enforceable nature of its medium-term budgetary framework as well as closely monitor adherence to the budgetary targets throughout the year.

OECD reports:

1. 2003 Economic Survey conclusions:
    a. the 2001 economic slowdown in Ireland was closely linked to the bursting of the ICT bubble, but also reflected a deterioration in Irish cost competitiveness due to strong inflation in the sheltered sector of the economy, reflecting the combined influence of large wage gains emanating from the tradable sector, low productivity growth in the sheltered sector and the generally expansionary effects of very low real interest rates since Ireland joined the EMU;

b. the policy challenge in the short term was to ensure that both income expectations and public finances adjusted to a slower growth environment, so as to safeguard against deterioration in international competitiveness and ensure fiscal sustainability and the maintenance of a growth-supportive tax environment;

c. over a longer term, the broad aim of the authorities should be to ensure that the economy continued to grow at a reasonably high rate and policies should be more clearly oriented towards protecting the interests of consumers rather than producers;

d. although GDP growth remained high at 6% in 2002, GNP growth was significantly lower (2%), since much of the growth accrued to foreign owners in the biomedical and pharmaceutical sectors;

e. the economy had lost momentum since late 2002 with a further slowdown in exports and a substantial weakening in business confidence;

f. demand for labour had slackened, leading to a rise in the unemployment rate;

g. a weak trend was expected to prevail in 2003, but was forecast to give way to modest acceleration in 2004 on the assumed recovery in export markets. Construction activities were likely to remain a major source of buoyancy due to rapid development of the physical infrastructure and continuing strong demand for housing;

h. while the 2001 and 2002 Budgets had substantially overestimated revenues and underestimated spending pressures, the 2003 budget seemed to be more consistent with slower underlying growth in the tax base: it relied on increased taxation and allowed for a smaller increase in spending that was allocated selectively to priority areas.

2. 2006 Economic Survey conclusions:

   a. as one of OECD's most open economies, Ireland was particularly exposed to external risks (declining exports and FDI);

   b. domestic risks were important too, of which the most prominent was the risk of overshooting housing prices. Although a soft landing was considered the most likely scenario, a sharper fall could not be ruled out;

   c. the Irish Government should balance its Budget or even run a surplus, curtail tax breaks (especially in the housing sector) and push ahead with public management reforms to get better value for money from public expenditure;

d. to prepare better for negative fiscal shocks the authorities should adopt a more top-down budgeting approach to help expenditure planning and control.

3. 2008 Economic Survey conclusions:
   a. economic fundamentals remained strong;
   b. in the short run, wage restraint and labour market flexibility were important to continue to attract FDI and to encourage foreign demand to offset the slowing down of domestic activity;
   c. in the longer run, stronger productivity growth, and continued increases in participation rates, would be needed to sustain a fast pace of real income growth;
   d. easing of activity had led to a slowdown in Government revenues and a sharp drop in the fiscal surplus; at the same time Government was committed to a large infrastructure investment programme and there was a strong demand for better public services;
   e. public finances faced serious pressures from the ageing of the population in the long run;
   f. Ireland was sensitive to weak US and UK demand for its exports and to lower FDI flows;
   g. although Irish finances were in a relatively good position as the country had achieved high growth rates in the past decade and a half, debt had diminished and the reserves in the pension fund had increased, public spending could increase and revenue growth had slowed down; therefore the Irish should commit to a more balanced fiscal policy.

IMF reports

1. 2000 Article IV Consultation conclusions:
    a. Commended the authorities for the performance of the economy over the past decade;
    b. signs of overheating had become more pronounced (rapid price increases in non-tradables, labour shortages, physical bottlenecks, rising property prices and rapidly growing private sector credit);
    c. expressed concern that rapid inflation could cause the social consensus underlying the wage agreement to erode and could lead to a difficult adjustment later, if the euro were to appreciate;
    d. increasing public investments in infrastructure, tax reforms to improve labour participation and deregulation and privatization to foster competition were needed while a tighter fiscal policy would help dampen excess demand;
    e. Directors called on the authorities to resist tax reductions above those in the national wage agreement;
    f. the planned benchmarking exercise was welcome although this should not come at the expense of overall public sector wage restraint;
    g. although Ireland had a sound and highly developed financial system, risks to financial sector stability could arise from rapid lending growth, in particular related to the domestic property boom;
    h. Directors expressed their concern that, after several years of rapid property price increases, housing demand might increasingly be driven by expectations of further price increases, a trend that could be abruptly reversed.
2. 2001 Article IV Consultations conclusions:
    a. Directors commended the authorities for Ireland's outstanding economic performance;
    b. the economic outlook remained broadly favourable, but authorities faced a number of challenges as growth adjusted to a lower, more sustainable, trajectory;
    c. the deterioration in the global outlook (especially for the technology sector) posed considerable downside risks;

d. Directors stressed the difficulty of managing a counter-cyclical fiscal policy in a small open economy and considered that the authorities should aim for a neutral policy in 2002;
e. Directors welcomed the efforts to improve the tax structure;
f. a number of structural reforms were considered desirable to help secure continued vigorous growth over the medium term:
    i. wage reforms, private sector wages should be market-determined and public sector wages aligned with those in comparable private sector jobs;
    ii. strengthening competition through privatization and deregulation;
g. Directors called for further progress to improve the coverage and timeliness of data necessary to monitor short-term developments.

3. 2002 Article IV Consultations conclusions:
    a. again commended the authorities for the impressive economic performance;
    b. the Irish economy appeared to have weathered the global slowdown relatively well;
    c. the economic outlook was broadly favourable;
    d. continued appreciation of the euro, combined with relatively high inflation and labour costs could adversely affect Ireland's competitiveness and strength of recovery; these factors could also pose a risk – albeit likely to be a manageable one – to the financial sector;
    e. Directors expressed concern about the sharp deterioration in the structural fiscal balance in 2001, but agreed that measures to unwind the stimulus for 2002 were not advisable at that time;
    f. the fiscal position for 2003 should, at a minimum, be kept neutral;
    g. capitalization of the banking system appeared to provide an adequate cushion against possible risks to asset quality, but supervisory authorities should ensure that capital and provisions remained adequate in the event of a deterioration in unemployment, company finances or property prices.
4. 2003 Article IV Consultations conclusions:
    a. Directors commended the Irish authorities for their exemplary track record of sound economic policies, but saw signs of sustained slower growth in the period ahead calling for a sharper policy focus on reducing inflation and improving competitiveness;

b. Directors noted that there was a significant risk that house prices could be overvalued, although financial sector risks appeared to be manageable;
c. Directors stressed the need for continued supervisory vigilance to ensure stability of the financial system;
d. While high levels of capitalisation and profitability had strengthened bank balance sheets, credit risks related to investor-owned housing properties, concentration of commercial property exposure among a few institutions and the health of the insurance industry merited close attention;
e. Directors emphasized the need of wage growth moderation in order to preserve external competitiveness and to avoid risks to employment;
f. Directors welcomed the somewhat contractionary fiscal stance envisaged for 2003, stressed that spending should be held to budgeted levels and that any revenue shortfalls be offset by restraint with respect to the wage bill and transfers, whereas capital spending should be protected;
g. Directors agreed that the authorities' medium-term fiscal target of overall structural balance was appropriate, but the authorities should not rely on continued strong output growth to eliminate the deficit.

5. 2004 Article IV Consultations conclusions:
   a. again commended Ireland's impressive performance which was based on sound economic policies providing useful lessons for other countries;
   b. economic recovery was expected to become stronger and broad-based in the short term, supported by external demand and a continued rebound in business investment;
   c. core inflation was expected to remain moderate;
   d. the main risks to this outlook stemmed from the potential for further euro appreciation and the possibility of an abrupt unwinding of the housing boom;
   e. in the medium term, Directors expected growth to be markedly lower, as many of the factors that accounted for the 1990s boom were one-off in nature;
   f. growth would still remain high by international standards;
   g. the transition to slower growth would require adjustments in expectations in labour and housing markets and also in fiscal policy;
   h. although inflation had decelerated –suggesting that expectations had adjusted to lower growth – the level of competitiveness had deteriorated;

i. Directors called for an extended period of wage restraint as well as increased wage flexibility within the social partnership;

j. while an abrupt unwinding of the housing boom was unlikely to cause concern about financial stability, the impact on employment and consumer spending could be significant;

k. many Directors warned against providing additional incentives in the form of subsidies to home ownership and urged the removal of interest-deductibility of mortgage payments on primary dwellings, as well as the introduction of a wealth tax on property;

l. although the overall outturn for 2003 and early returns in 2004 were better than expected, Directors noted that this performance was in part due to one-off factors.

6. 2005 Article IV Consultations conclusions:

    a. commended Ireland's continued impressive economic performance;

    b. Directors concluded that economic growth was expected to be strong in the short term, driven by an acceleration of consumption and continued robust business investment;

    c. with a gradual cooling of the housing market, residential investment would likely decline modestly starting in the following year;

    d. the main risks to the outlook were considered to be: (1) a further rise in oil prices, (2) an abrupt slowdown in global economic growth, (3) a sharp decline in the housing market and (4) rapid growth of aggregate demand giving rise to wage pressures, thereby undermining external competitiveness;

    e. Directors noted that the 2005 Budget imparted a considerable fiscal stimulus while euro area monetary policy was very accommodative for Ireland;

    f. Directors underscored the importance of building a fiscal cushion in good times, in the event of downside risks materialising;

    g. the conduct of Ireland's fiscal policy had been laudable over the years and, while an enhanced public debate could help, any Directors did not see a case for a fiscal council.

7. 2006 Article IV Consultations conclusions:

    a. Ireland was again commended though growth had become increasingly unbalanced;

b. Directors expected economic growth in 2006-07 to remain strong, driven by domestic demand and accompanied by a widening current account deficit and continued rapid credit growth;
c. while the contraction of the construction sector to a more sustainable size over the medium term was likely to be smooth, Directors noted that an abrupt correction could not be ruled out;
d. while recognizing that Ireland's fiscal position was sound, most Directors considered that a modest fiscal tightening would be desirable in 2007, given the strength of domestic demand, potential risks of a hard-landing and the need to prepare for population ageing, although a number of Directors saw less merit in fiscal tightening at that juncture, pointing to the need for further spending to achieve social goals and the recent tightening of euro area monetary policy;
e. Directors considered that continued wage moderation and labour market flexibility were essential to support competitiveness and broadly welcomed the new social partnership agreement.

8. 2007 Article IV Consultations conclusions:
   a. commended Ireland's continued impressive economic performance, characterised by one of the highest growth rates of GNP per capita among advanced countries, underpinned by prudent fiscal policy, low taxes and labour market flexibility;
   b. Directors expected economic growth to remain robust over the medium term, but urged that careful attention be paid to of a number of downside risks: i.e. inflationary pressures, declining competitiveness, a widening of the current account deficit, a deterioration in global financial market conditions, the growth outlook of the US and the adjustment to a cooling of the housing market;
   c. while the slowdown of the housing sector had been gradual so far, a sharper correction in house prices could significantly slow economic growth;
   d. Ireland's medium-term fiscal discipline was commended, but many Directors saw the planned reduction in the 2007 fiscal surplus as an undesirable pro-cyclical fiscal stimulus;

e. Directors encouraged the authorities to restrain current expenditure growth and to continue to focus on improving the quality of public spending through cost-benefit analysis;
f. Directors concurred that Ireland was well-placed to meet the fiscal challenges of increasing age-related spending over the long term;
g. although Directors welcomed the indicators including stress tests that confirmed the soundness of the Irish banking system, financial sector vulnerabilities required continued supervisory vigilance;
h. Directors stressed that preserving and enhancing Ireland's external competitiveness through wage moderation would be key to underpinning future growth prospects.

9. 2009 Article IV Consultation conclusions:
    a. Directors noted that Ireland had been hit particularly hard by the global economic and financial crisis and that critical macroeconomic imbalances had emerged as credit supply accommodated an unsustainable rise in property prices;
    b. Directors commended the scale and speed of the authorities' response, while noting that such efforts needed to be sustained over an extended period of time;
    c. Directors supported the efforts to restructure the financial sector, including the decision to establish NAMA and urged risk-sharing in the pricing of distressed assets;
    d. Directors welcomed the fiscal measures already taken, including significant, and politically difficult, cuts in public sector wages.
10. 2010 Article IV Consultation conclusions:
    a. Directors considered that the authorities' decisive measures to support the banking sector and advance fiscal consolidation had helped gain policy credibility and stabilize the economy, and encouraged them to sustain these efforts;
    b. Directors noted that vulnerabilities remained high and required effective mechanisms for oversight and transparency to minimize risks and sustain market confidence;
    c. Directors concurred with staff's analysis that the speed of the recovery was likely to be moderate with relatively limited growth and high unemployment,

and noted in this context, that structural reforms aimed at regaining competitiveness and boosting potential output were necessary to put the recovery on a sustainable track;

d. Directors observed that a sizeable agenda remained to strengthen the banking sector;
e. Directors emphasized the need to strengthen the financial stability framework;
f. Directors underscored the importance of adhering to the further consolidation targets going forward and agreed that the consolidation plan would benefit from greater specificity;
g. Directors encouraged the authorities to move further towards a medium-term Budget framework and to adopt a fiscal rule and establish a fiscal council to advise on risks underlying public finances.

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
National																					
New House Prices (Euro)	65,541	66,914	69,264	69,883	72,732	77,994	87,202	102,222	125,302	148,521	169,191	182,863	198,087	224,567	249,191	276,221	305,637	322,634	305,269	242,033	228,268
		2.1	3.5	0.9	4.1	7.2	11.8	17.2	22.6	18.5	13.9	8.1	8.3	13.4	11.0	10.8	10.6	5.6	-5.4	-20.7	-5.7
Second Hand House Prices (Euro)	62,387	64,122	65,331	66,736	69,877	74,313	85,629	102,712	134,529	163,316	190,550	206,117	227,799	264,898	294,667	330,399	371,447	377,850	348,804	275,250	274,125
		2.8	1.9	2.2	4.7	6.3	15.2	20.0	31.0	21.4	16.7	8.2	10.5	16.3	11.2	12.1	12.4	1.7	-7.7	-21.1	-0.4

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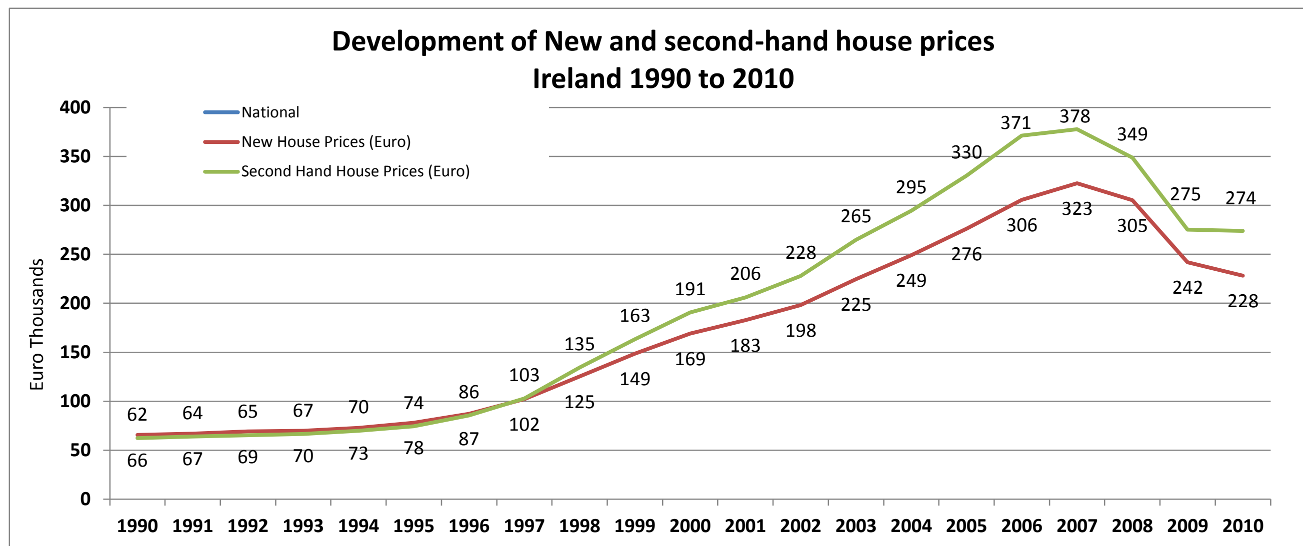


THEME: R1

Effectiveness of the regulatory, supervisory and governmental regime structure

LINE OF INQUIRY: R1d

Composition, skills, experience and number of resources at the Central Bank, Regulator and Department of Finance

EPD/012/036/02 Part 2

(236)

Management Meeting

Wednesday, 1 May 2002 (9.30 am)

Venue: Conference Room .3, Ground Floor, South Block

Agenda

1. **Approve draft minutes of 22 April, matters arising**
2. **Update on Expenditure, Taxation, Pay and 2002 Budget**
3. **MIF**
4. **Presentation on Medium Term Prospects**
5. **Staffing Issues (paper to follow)**
6. **A.O.B.**
7. **Next Meetings:**

SMI Reviews:
9 May @ 10.00 am - B McManus
15 May @ 10.00 am - E Kearns
17 May @ 2.30 pm - C O'Loghlin
20 May @ 2.30 pm - A Dunning

29 **April 2002**

C O'Loghlin, C Connolly, C Gallagher, K Cardiff, J O'Brien and M Scanlan to attend

EPD/012/035/02 Part 2.

(175)

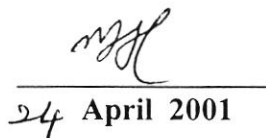
Management Meeting

Thursday, 26 April 2001 (9.30 am)

Venue: Conference Room 0.3 Ground Floor, South Block

Agenda

1. **Approve draft minutes of meeting of 19 April (draft attached), matters arising**
2. **Update on Expenditure, Taxation, Pay and Budget**
3. **Group on Recruitment and Retention (paper attached)**
4. **A.O.B**
5. **Next meetings:**
   27 April (10.00 am) SMI Review - C Gallagher
   4 May (2.30 pm)



24 **April 2001**

B. McManus, J. O'Brien, J. McGovern, E. Embleton and M. Scanlan will attend this meeting

EPD012/036/02/PART001

Minutes of Management Meeting on 28 February 2002

(46)

Attendance: Secretary General, Secretary General PSMD, David Doyle, Donal McNally, Noel O'Gorman, Ciaran Connolly, Colm Gallagher, Aidan Dunning and Michael Scanlan.

Apologies: C. O'Loghlin

Agenda Item 1: Minutes and Matters arising

The minutes of 20 February were approved. There were no matters arising.

Agenda Item 2: Update on Expenditure, Pay and Budget

Mr Doyle said that the REV had been published earlier to-day. The Revised Estimates include spending measures announced on Budget Day together with some adjustments arising since across Departments involving a net increase of €39 million. On the basis of the REV and a provision of €150 million for Benchmarking, total net voted expenditure in 2002 will be €29 billion (€23.38 billion current and €5.62 billion capital) an increase of 14.8% on projected outturn for 2001. There will be ongoing pressure on expenditure arising from Environment and Health in particular. Mr McNally reported that tax receipts showed "some slight improvement" in February but the underlying trend in income tax and stamp duties remains weak. Mr Considine briefed the meeting on developments in relation to ASTI and the contingency arrangements being put in place to deal with the industrial action scheduled to commence on 4 March. Mr Connolly reported on the ASTI stance regarding pensionability and the recent claims made by School Secretaries. Mr Considine updated the meeting on developments in relation to the claim made by Medical Laboratory Technicians and the wider implications for the public service. He informed the meeting of the CPSU's intention to hold a Delegate Conference following the publication of the report of the Benchmarking body in June 2002.

Item 3: Establishment of IFSRA - Implication for the Department

A paper entitled "Establishment of IFSRA: Implications for the Department of Finance" was circulated to the MAC as the basis for discussion. Mr J. Doyle and Mr M. Moloney made a presentation on the new functions and likely key priorities which will transfer to the Department on the establishment of IFSRA, possible staff resources implications and the current position in relation to transfer transitional arrangements. The following matters were addressed

- New functions and possible key priorities
- Functions which should not transfer to this Department
- Internal organisation
- Timescale for transfer of functions

Mr J Doyle said that a Memorandum for the Government seeking clearance for the Central Bank of Ireland and Financial Services Authority (No.1) Bill will be submitted as soon as possible. This Memorandum will also advise Government of our intention to consult with the other relevant Government Departments and submit a further Memorandum regarding departmental responsibility for the functions currently carried out by the Minister for Enterprise, Trade and Employment which are not transferring to this Department.

Minutes of MAC Meeting on 31 May 2004

Attendance: Secretary General, Secretary General PSMD, David Doyle, Donal McNally, Derek Moran, John O'Connell, Colm Gallagher, Kevin Cardiff, Jim O'Brien, Carmel Keane.

Apologies: Noel O'Gorman

Agenda Item 1: Approval of draft minutes of 24 May

The minutes were approved subject to drafting amendments at Item 2. There were no matters arising.

Agenda Item 2: 2004 Budget, Expenditure, Taxation and Pay

Mr Doyle reported a total net voted expenditure increase of 4.6% against a target of 7%. No significant changes in expenditure were anticipated. Mr McNally reported that overall tax receipts were 9.7% ahead of the same period in 2003. He updated on receipts and emerging trends under the main tax heads. The Secretary General, PSMD reported that a plenary meeting on the second phase of the Sustaining Progress Pay Talks was scheduled to take place on 4 June. He updated on ongoing industrial action by Prison Medical Officers which has been referred to the LRC and on the dispute with POA which will go to arbitration.

Agenda Item 3: Budget 2005

The MAC reviewed work in progress in the preparation of the Budget Strategy Memorandum. The current economic forecast and overall objectives were discussed. The Memorandum is scheduled for inclusion on the Government agenda at end June.

Agenda Item 4: Update on EU Presidency

Mr McNally reported progress of the Savings Directive. He updated on tax issues arising in the context of the IGC and on the agenda for the forthcoming EFC meeting. Mr Cardiff reported on the Financial Services Conference due to take place in June. Mr O'Connell reported on the outcome of the EPAN meeting which took place in Dublin Castle on 26-28 May.

Agenda Item 5: Decentralisation

Ms Keane reported on the Decentralisation Plan for the Department which describes the people, property and business issues to be addressed. She said the document before the meeting was the initial outline of the decentralisation implementation plan for the Department. It will go through successive and repeated iterations and will progressively address all facets of decentralisation. The plan was prepared in response to the requirements of the Flynn Report. It deals with the decentralisation of 134 posts to Tullamore. A separate plan will be developed for the additional 32 posts to the ICT cluster whose location has yet to be decided.

The MAC discussed the draft plan. It was agreed that any further comments would be sent to CSD by close of business on Wednesday, 2 June.

Agenda Item 6: Progress Report on PVG

The MAC approved for submission to the Civil Service Performance Verification Group, the draft report on Progress with the Civil Service Modernisation Programme, subject to amendments on pages 4, 7, 12, 14, 15. This report was prepared in collaboration with the Department of the Taoiseach. It was agreed that copies of the report when completed would be circulated to the Partnership Committee.

Agenda Item 7: Monthly Financial Report

The MAC noted the Financial Report to month ended 30 April. The MAC agreed that the additional information contained in Part 3 added value to the report.

Agenda Item 8: Progress Report on MIF Project

The MAC approved the Summary Progress Report to the MIF Central Unit.

Agenda Item 9: AOB

The MAC approved the assignment of a Principal Officer to BED and noted that the vacancy at PO level in CMOD would be filled by internal competition.

Agenda Item 4: Update on EU Presidency

Mr O'Sullivan reported on the June ECOFIN Council. The MAC acknowledged the excellent support provided by the EU Sections and the Permanent Representation staff in organising a very successful meeting. Mr Cardiff reported on the forthcoming European Commission Conference on the Financial Services due to take place on 22 June. It was agreed that Ms McManus would attend the European Council meeting on 17/18 June.

Agenda Item 5: Decentralisation

The Secretary General, PSMD reported that discussions on industrial relations issues with the public service unions were ongoing and a number of complex issues would have to be resolved. It was envisaged that information gathered through the CAF would be analysed by the CSC and passed on in summary form to the Flynn Group. A decision by Government on the location of the ICT clusters is awaited and given the delay it may be necessary to extend the date for Phase I of the CAF.

Ms Keane said that the Implementation Plan for the decentralisation of 134 posts to Tullamore had been completed and would now be forwarded to the CPU. A meeting with the bodies under the aegis of this Department had taken place and the relevant implementation plans were well advanced in each case and they would be forwarded to the CPU this week.

Agenda Item 6: Annual Report

Discussion on the Progress Report on the Department's Statement of Strategy for 2003 was deferred to the next meeting. It was agreed that comments/amendments to the draft report should be sent to CSD.

Agenda Item 7: Annual Conference

The MAC approved the Conference theme and the framework for the Annual Conference which is scheduled to take place on 23 September. It was agreed that the main internal speaker would be a member of the Principal Officer Group. It was also agreed that Mr Paul Haran, Secretary General, Department of Enterprise, Trade and Employment should be invited to be the guest speaker. The programme should be amended to afford more time to roundtable discussion of the issues.

To MAC for meeting 26 April 2001

Group on Recruitment and Retention

with input from the Assistant Secretary Group

Summary

The paper is in three parts: recruitment, retention, and career development. It analyses the skills challenge facing the Department, identifies the main areas of concern, and sets out a number of recommendations. The main proposals are:

Recruitment

A that the Department should aim to attract two types of graduate, specialist and generalist, in the proportion 60:40 [2.1(a)];

B that selected college students be sponsored with a view to securing their commitment to serve as AOs in the civil service for a minimum period [2.1(b)];

C that the AO competition confined to serving civil servants be run annually [2.1(c)];

D that the name "Administrative Officer" be replaced by one which is more appropriate to the changing times [2.1(d)];

E that some measure of recruitment take place above AO level [2.1(e)];

F that all future AP1 and PO1 competitions take place before the corresponding AP2 and PO2 competitions [2.1(f)];

G that the eligibility period for AP1 be brought into line with that for AP2 [2.1(g)];

H that the CSC run special competitions to recruit AOs exclusively for this Department [2.1(h)];

Retention

I that all AOs and HEOs in their first year be given special projects or assignments which would test their aptitude and potential [2.1(i)];

J that BED receive suitably qualified staff on secondment from both the Central Bank and the ESRI [2.1(j)];

K that the skills audit, currently under way, be used to to identify staff with skills in short supply [2.1(k)];

L that CSD, using information supplied by individual A/Secretaries, determine whether the overall level of clerical support in the Department is satisfactory and whether a more even distribution is warranted [2.1(l)];

M that the introduction of a suitable mechanism for recognising exceptional performance be further explored [2.1(m)];

Career Development

N that APs with a deficiency of skills in staff development be identified via PMDS and appropriate training supplied [2.1(n)];

O that consideration be given to the possibility of assigning a mentor at AP/PO level to each AO/HEO coming into the Department [2.1(o)];

P that all AOs and HEOs attend the Policy Analysis Programme [2.1(p)].

1. Issues of concern

Skills challenge

1.1 The Department is facing a specific skills challenge, both short term and long term. Too many experienced staff are leaving (interdepartmental promotions, decentralisation, career breaks, private sector offers). Many experienced staff are also coming up to retirement.

Skill requirements

1.2 The Department has a broad spectrum of specific skill requirements:

Policy Analysis
- o Policy Analysis (including public administration) -- an essential skill for all managers.

Economics
- o Economics -- macro, labour and modelling in BED, as well as micro in PED and in relation to the NDP.

Financial
- o Banking and finance -- financial instruments, capital adequacy, banking regulation, financial intermediaries, prudential considerations, monetary policy, etc;
- o Accountancy -- in PED and BFI;
- o Actuarial -- PRD.

HRM/IR	o	Human resource management -- PRD, OMT, CSD;
	o	Industrial relations -- PRD, OMT, CSD;
	o	Training -- CSD, CMOD.
Legal	o	Legal -- Department-wide, but notably PED (including PPP), PRD, machinery of Government, and the Finance Bill, while an understanding of many aspects of Irish, EU and international law is required in several other areas of the Department.
IT	o	IT and telecommunications -- CMOD.

The Department has been aiming in recent years to secure an adequate supply of necessary skills without creating a situation where general mobility is impaired by a surfeit of specialists. Even where specialists are recruited, we would expect them to move outside their initial area of assignment after a reasonable period. There is therefore a need to recruit a mimimum cohort of specialists on an ongoing basis.

1.3 The Department also requires that the majority of its senior personnel possess a range of general management skills. The seven core competencies for the Department, approved by the MAC, are as follows:

Team-working
Decision Making/Judgement
Analytical Thinking
Leadership
Networking and Influencing
Managing and Developing People
Information Seeking and Management.

Managers are also expected to possess basic attributes such as commitment, good judgement and confidence, along with communications skills and problem solving ability. A flexible approach to complex issues is also required, an adaptable mindset which can take full account of the wider context.

1.4 Few staff are recruited with a view to exploiting a particular skill or qualification. The main areas where this occurs are economics, accountancy and law. Most other skills are developed through the selection of suitable staff for on-the-job and post-entry training. At present, the main skills in short supply are economic modelling along with banking, accounting and legal skills.

1.5 The Department also has a need for a cohort of managers with a strong intellectual competence. It has traditionally been able to identify such individuals from those members of staff, including graduates, who have demonstrated exceptional ability. The drain on resources, plus the change in the graduate recruitment patterns as high calibre candidates are "creamed off" by the more proactive private sector, has meant that the pool of individuals recruited in this category needs to be further improved. This is necessary if the Department is to continue to recruit and retain an adequate cadre of very well qualified, articulate and intellectually strong "thinkers". Graduates with a good honours degree in subjects like History, Politics, Engineering, English, Business Studies, the Classics, Philosophy, Psychology and Sociology are likely to possess the literacy and analytical ability required, though high performers in any discipline should have the necessary potential.

1.6 The recent Review Body Report (No.38) confirmed the need for a more proactive approach in this regard: "...it is equally important to recognise that developing and retaining top quality talent requires action on a broad front. The public service must also move decisively to adopt more proactive career management strategies and better human resources practices to retain and develop its best people in the early stages of their careers. A much more active role for managers in the identification of such people is necessary to develop leaders at all levels, give them more challenging opportunities, help outstanding performers to progress rapidly in a variety of Departments and roles, and to educate and train them in the most modern and appropriate management and analytical disciplines." [2.12]

Delays in filling vacancies

1.7 Difficulties in securing new recruits in all grades above CO level has given rise to long delays in filling vacancies. The average number of vacancies at any one time across the Department has reached record levels, especially in the AO grade, with some sections reporting delays of 6-9 months.

1.8 Delays in filling vacancies have hampered mobility, frustrated the transfer of skills, and put existing staff under increasing pressure.

1.9 Delays in filling vacancies have also made it more difficult to operate job-sharing, career breaks, and term-time.

1.10 Some grades, notably HEO and AO, have lost so many experienced staff that there are now problems filling promotion posts when they arise.

Perception of the Department

1.11 The perception that the Department of Finance operates a long-hours culture, with slow rates of promotion relative to the service as a whole, and with inadequate delegation of responsibility to trainees and posts at middle management levels, is believed to be discouraging candidates on interdepartmental AP panels from accepting offers of promotion to this Department (Other factors may also be at work, e.g. candidates may be applying for an interdepartmental API competition primarily to increase their standing in their parent Department). ***[PRD to supply results of survey of candidates who turned down AP1]*** The report, "Gender Equality in the Civil Service" (1999) -- in which this Department participated as one of the three case studies -- provides further evidence that, as an employer, the Department is perceived as less attractive than the norm. Also, many AOs and HEOs report that too much of their time is taken up with duties more appropriate to staff in lower grades.

1.12 The Group believes there is considerable validity in these criticisms and that they need to be addressed by management [A detailed discussion paper is currently before the PO Group on the "Management Style and Culture of the Department"]. The Department needs to do more to promote its image, both among serving civil servants and among college students. For example, consideration could be given to holding information seminars on the work of the Department and adding appropriate career information to our web site. The criticism that the Department operates a "long-hours culture" should also be addressed by stating that, with very few exceptions, individual work assignments should require attendance during normal hours only and that, where recurring departures from the norm are identified, the organisation and resourcing of the area concerned should be reviewed.

1.13 The availability of job-sharing has allowed the Department to retain experienced staff in recent years who would otherwise have left. These were mainly staff with personal responsibilities in the home. The imminent introduction of Worksharing, which will enable staff to work for a few days a week (for any reason), will increase the scope for flexible working. This would be of particular interest to graduates who want to continue with their studies while also gaining valuable work experience and additional income. The Department should more widely advertise the family-friendly options available to all new entrants, viz job-sharing, work-sharing, term-time, career breaks, and (at least informally in one or two areas) teleworking.

Tight labour market

1.14 The tight labour market means that private sector employers are increasingly vying with the civil service for the same pool of recruits. This means that, not only is the Department having difficulty filling existing recruitment vacancies with high calibre staff, but the pool of candidates for future internal recruitment is being correspondingly diluted. The tight labour market is also inducing more private sector employers to look to the civil service as a potential source of recruits.

Long-term implications of drain on skills

1.15 The long term implications of this ongoing drain on skills are potentially serious. For example, the Department may in due course lack the skills to analyse developments to the depth required and to formulate effective policies for certain sectors, particularly those where a detailed familiarity with a diversity of issues is essential. The cross-sectoral analysis of issues would also be compromised and the wider strategic implications of certain policy outcomes rendered more difficult to predict. Since public policy formulation has wide-reaching implications for the economy as a whole and since many decisions in relation to such areas as infrastructure, competition, regulation and industrial development have major implications spanning many decades, it is essential that the Department deploy the highest level of skills in analysing developments, formulating policy and recommending proposals to Government.

1.16 Many of these problems are being experienced by other Departments.

2. Proposals

2.1 The Skills Group recommends the following proposals for addressing the concerns raised by the Assistant Secretary Group. It recognises that factors specific to the IT area, particularly in relation to turnover, training, the high number of IT specialists needed by the Department (relative to other specialist categories), career development, and organisational arrangements, may necessitate consideration of additional steps to ensure that future skill needs in that area can continue to be met.

RECRUITMENT

(a) Educational Qualifications

The Department should aim to attract two types of graduate: those with specific skills required by the Department listed at paragraph 1.2 above, and those with an educational background which will (i) enrich the approach taken by the Department in analysing and formulating policy and (ii) enable the individuals concerned to adapt easily to most areas of the Department's work. All recruits should be amenable to further training and development. The mix of graduates most likely to address the Department's skills needs for the foreseeable future is a "specialist" to "generalist" ratio of 60:40.

(b) Targeting undergraduates

The civil service should introduce a programme whereby undergraduates are sponsored at £2500 (on the basis of their second year results) in their final year of study, on the understanding that they will commit to entering the civil service as AOs (or equivalent) for a minimum period of, say, three years. Legal advice could by sought regarding the enforcability of a contract of this nature. Arrangements of this kind appear to have worked well enough in the private sector and could be expected to attract recruits who would not otherwise have considered a career in the public service.

Candidates would be told that:

- after 4-5 years they would be expected to progress to policy analysis work at senior level (AP);
- they would be encouraged and funded to pursue post-graduate study.

The normal annual AO competition would continue to take place.

Candidates would be selected through a special competition aimed at students in their penultimate year of study. The competition should conform with the Civil Service Commissioners Act, though the assistance of the colleges could be sought in selecting undergraduates. Proposals to revise this Act, which are currently under consideration, should include a provision to further facilitate this method of recruitment.

This programme would be run for the entire civil service. Costs are likely to be of the following order:

Say 50:	sponsorship at £2500	£125,000
Say 25:	post-graduate fees	£125,000
	sponsorship at £3000	£75,000
	Annual cost	say £350,000

The cost of this investment would be balanced by the long-term injection of top calibre recruits into the civil service. Funding could be sought from the Change Management Fund.

While a guarantee of promotion after, say, five years, would prove attractive to many graduates, it could convey the impression that non-competitive advancement was a normal part of civil service career development. The Skills Group would suggest instead that AO/Policy Analyst recruitment literature highlight (a) the earning potential of the job ("We would expect you to be earning £xx,000 after five years"), (b) the scope for promotion ("Most AO/Policy Analysts are promoted after X years through a competitive process"), and (c) the scope for awarding up to four additional increments on recruitment for skills, qualifications or experience of particular relevance to the work of the Department.

(c) Targeting EOs and HEOs

Currently, the CSC runs an occasional AO competition confined to serving civil servants. This should be held annually in order to facilitate the early identification and advancement of promising staff in lower grades, notably at EO level. It would also provide an incentive to both EOs and HEOs to pursue a further course of study to enhance their qualifications.

(d) Name change

The title "Administrative Officer" is out of date. In some public administrations it refers to an officer of lower rank. It also says little to indicate the vocational activity involved. The Skills Group recommends that a suitable alternative be identified, one which would prove more attractive to graduates and present a more career-focused image of the Department and the civil service generally. The title "Policy Analyst" has been suggested.

(e) Recruitment above AO level

The civil service should not restrict itself to recruiting at a level no higher than AO. A percentage of posts at AP level and higher should be filled through open recruitment, with a view to attracting high achievers from the private sector, former civil servants (including women who wish to re-enter the labour market), and public servants from outside the civil service who wish to pursue a career in a central government department. While there are significant IR implications in this proposal, the Skills Group would consider that most of what is being proposed could be accommodated through the existing provisions for atypical recruitment.

(f) Timing of AP1 and PO1 panels

The Department loses many good officers to AP2 and PO2 panels where these are announced in advance of the AP1 and PO1 panels. Experience has shown that where an officer of the Department succeeds in getting on an AP2 or PO2 panel and subsequently takes up an offer from another Department, he/she is reluctant to return to this Department when offered AP1 or PO1. The Skills Group strongly recommends that all future AP1 and PO1 competitions take place before, and are announced before, AP2 and PO2 competitions.

(g) Eligibility for AP1

The eligibility period for AP1 is 4 years, while it is only 3 years for AP2. Experience has shown that many of the Department's AOs and HEOs are not prepared to wait an additional year in order to become eligible to compete for AP1, which further increases the Department's losses. The Skills Group would strongly recommend that the eligibility period for AP1 be reduced to 3 years, in line with that obtaining for AP2. In making this recommendation, the Group is conscious of the IR implications.

(h) Special AO competitions for the Department

The CSC should be asked to run special competitions to recruit AOs exclusively for this Department. In doing this, the Department would need to be able to guarantee the CSC that a sufficient number of suitable interviewers would be made available. The AO candidature could be reduced to manageable levels by requiring applicants to complete a detailed questionnaire which would enable their performance against recognised indicators to be assessed (e.g. Leaving Cert results by subject, results in First and Second Year exams, special projects, other qualifications, non-academic achievements). A team of external assessors could be recruited by the CSC to draw up a short list using anonymised application forms.

[It should be noted that a special AO/Economist competition is being run for the Department by the CSC at present, as part of the main AO competition. Candidates possessing appropriate qualifications in economics or a related discipline are being singled out and interviewed on behalf of the Department and, where successful, placed on a panel exclusive to the Department.]

RETENTION

(i) AOs in their first year
The Department cannot expect to retain AOs and HEOs who are not being given challenging work or adequate direction. All new entrant AOs and HEOs should be given special projects or specific assignments which would test their written communication and analytical ability, as well as their judgement and their capacity to carry a project through to completion. There should be no question of retaining anyone who fails to perform well in this regard. The projects should be completed in all cases in 12-15 months.

(j) Secondments
The Department has not made much use of work experience and similar options to attract suitable recruits on a temporary basis or to increase the skills and experience of existing staff. The availability of an option to go on temporary secondment to relevant outside employers (Central Bank, ESRI, financial and other firms in the private sector, and semi-state bodies) may prove attractive to potential recruits and assist in retaining existing staff. Similarly the Department should be providing inward opportunities to suitable candidates. In view of the existing skills shortages in BED, the Skills Group recommends that both the ESRI and the Central Bank be asked to second a number of suitably qualified officers to the Department for a period of 3-5 years.

(k) Skills Audit
Many officers are acquiring, or have already acquired, qualifications of particular relevance to the work of the Department, including legal skills, accountancy, IT, HRM degrees, etc. The skills audit, which is currently under way, will help in identifying staff with skills in short supply and will provide useful background information when deciding assignments.

(l) Clerical Support
Some staff, notably AOs and HEOs, have expressed concern at the disproportionate amount of their time spent on duties appropriate to a lower grade. Individual Assistant Secretaries will report direct to CSD by end-April 2001 on the adequacy of clerical support in their respective areas. Regard will be had to reporting arrangements at clerical level and the degee to which staff in allied areas can avail of local clerical resources. The information from this exercise will enable CSD to determine whether the overall level of clerical support in the Department is satisfactory and whether a more even distribution is warranted.

(m) Selecting posts for particular recognition

The Department has no means of giving additional remuneration to officers in posts requiring significant dedication or skills above the norm for the grade. The poaching of our best staff by the private sector is facilitated by the absence of a suitable mechanism for recognising exceptional performance. The Skills Group is of the view that a practical means of addressing this should be further explored.

CAREER DEVELOPMENT

(n) Cultivating existing talent

The Department needs to give more time to staff development. Significant advances have already been made on foot of the Training Needs Analysis and the enhanced staffing of the DTU. However, local managers must become more actively involved in developing their staff and in identifying officers with strong management potential. There is evidence to suggest that many APs lack the skills needed to develop their staff, notably those at AO and HEO level. The PMDS should be used to identify where these deficiencies exist and to take any necessary follow-up action.

(o) Mentoring

Many AOs, HEOs and other staff have commented on the difficulties they experienced in becoming integrated into the Department. Consideration should be given to the introduction of some form of mentoring arrangement. A scheme of mentoring would assist new entrants by increasing their self-esteem, strengthening their grasp of the way the organisation works, and making it easier for them to envisage their future career within the Department. Mentors at AP/PO level would come from outside the section where the individual is working.

(p) Post-entry training and development for AOs and HEOs

All new AOs and HEOs should attend the Policy Analysis Programme, in addition to other courses considered to be of developmental importance by their supervisors.

David Doyle, Chairperson
Kevin Cardiff
Pat Casey
Patricia Coleman
Mary McKeon
Aine Stapleton
Simonetta Ryan
Robert Pye, Secretary

23 March 2001

[with modifications suggested by the Assistant Secretary Group, 5 April 2001]

Blaithin Nic Giolla Rua

From: McCarthy, John
Sent: 16 January 2009 16:45
To: quinn terry
Subject: FW: Article by G Fitzgerald in Saturday's Irish Times

Opposition to Civil Service economists a costly error
GARRET FITZGERALD

The Department of Finance's estimates have contributed to our economic difficulties

I AM CUT off temporarily from some of my data bank because of a brief stay in hospital, as doctors reconcile treatment of a lung deficiency with my late-onset diabetes. However, this week I wanted to address an aspect of our economic crisis that does not require statistical data – the respective responsibilities of the Civil Service, specifically the Department of Finance and of politicians, in economic policymaking.

The two roles of the Civil Service are to advise on policy and then, after the Government has decided what to do, to implement its decisions. For their part governments are, of course, free to ignore rather than take advice tendered to them.

I strongly suspect that the serious policy mistakes this Government has made since the end of the 1990s, which have left us so vulnerable to the global credit crunch, have been mainly the result of a failure to take much good advice given to it by the department over recent years.

That department may nevertheless also share some responsibility for the course that events have recently taken.

When I was taoiseach there were 17 economists working in the department. When I last checked a few years ago, there were only three, only one of whom was working on macro-economic issues, eg on policy issues related to the performance of the economy.

I had been moved to raise this issue because of some very wide margins of error that had occurred in the department's revenue forecasts. These had involved substantial underestimations that had tempted then minister for finance Charlie McCreevy to seek popularity by dissipating these apparent surpluses.

Why did the number of qualified economists at the crucially important assistant principal grade in the department fall so low? I suspect because of opposition by the administrative side of the Civil Service to recognition of a professional grade of economist in the public service.

A result of this policy has been that a qualified economist entering the Civil Service is precluded from a normal career in the department.

Because of this, so many qualified economists have left the department that it has been unable to meet its staffing needs in this area. In the 1980s, before the problem posed by this policy was recognised, these staff needs were well provided for.

It has indeed been reported that some years ago, the department was so frustrated by its own policy that it felt it necessary to ask the National Treasury Management Agency, which was free from such staffing constraints, to employ an economist at that agency's substantially higher pay level and then to lend that economist to the department for a period.

This has been an absurd, ramshackle and dangerous approach to policymaking. The absence of an adequate number of qualified staff on the macro-economic side of the department policy area is indefensible and has contributed significantly to our current economic difficulties.

This complex and highly technical side of its work should, as is the case in the ESRI, be undertaken by an adequate team of qualified economists, specialising in macro-economic analysis. This is a criticism of the department's organisational arrangements, not of any individual official.

Dr. Garrett Fitzgerald
c/o The Irish Times
24-28 Tara St
Dublin 2

21 January 2009

Dear Dr. Fitzgerald,

In a recent article entitled "Opposition to Civil Service economists a costly error" (Irish Times 10 January 2009) you raised issues relating to the economic capacity of the Department of Finance. In this regard, I wish to comment on a number of points. At the outset, you will appreciate that given recent events, I am only now finding time to respond. In overall terms, I do not agree with your comments about the expertise within the Department, which have subsequently been reported as fact in other fora.

Firstly, the Department has a number of highly qualified people working on economic issues, including macro-economic ones. Of those employed in the Department, over 80 officers hold degrees in economics at various levels. Many of these have considerable experience in macro-economic analysis.

Moreover, it is not the case that there is no career structure for economists in the Department of Finance. The Department has had a long standing policy of hiring economists. Individuals with economic skills and qualifications are employed at almost all levels of the Department, including the highest levels, and economists are in the same position as others in terms of applying for promotion to senior levels. For instance, of the last 7 appointments to Assistant Secretary level, 5 had masters qualifications in economics or related disciplines while 2 had primary degrees in economics or related disciplines. So the suggestion that the Department cannot acquire or provide a career structure or retain good analytical staff simply does not stand up.

I do not propose to comment on whether the Department does or does not get its forecasts right or wrong. Suffice to day that we are in very good company, and objective assessment of projections, undertaken at the same point over the last few years, bears this out. Equally I will not comment on the advice we may have given, or not. The history books can judge that.

In summary, I am satisfied that the calibre and commitment of the economic staff ensures that quality economic and budgetary advice is provided to Government.

Yours sincerely,

David Doyle
Secretary General

Parliamentary Question: 17 December 2008

199. Deputy Joan Burton asked the **Minister for Finance** the number of people working in his Department; the number of qualified economists, having a masters degrees in economics, PhD's in economics, and the number of qualified accountants working at his Department; and if he will make a statement on the matter. **[46950/08]**

Minister for Finance (Deputy Brian Lenihan): There are currently 614 people (whole time equivalents) employed in my Department. There are currently 57 officers who hold degrees in Economics and related disciplines, 44 who hold a Masters qualification in Economics and related disciplines, and 1 officer who holds a PhD. Some officers will, of course, be included in more than 1 of these categories. There are 7 officers with professional accountancy qualifications. In addition, a further 10 staff have degrees in Accounting or accounting related disciplines.