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(Fiosrúcháin, Pribhléidí agus Nósanna Imeachta), 2013

REPORT of the Joint Committee of Inquiry into the Banking Crisis

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

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THEME: R2

Effectiveness of the supervisory practice (Central Bank, Financial Regulator and Department of Finance)

LINE OF INQUIRY: R2a

The effectiveness of the use of supervisory powers

EUROPEAN COMMISSION - PRESS RELEASE

State aid: Commission approves restructuring plan of Hypo Real Estate and clears the aid

Brussels, 18 July 2011 – The European Commission has approved under EU state aid rules restructuring aid consisting of capital injections of € 10 billion, an asset relief measure with an aid element of about € 20 billion, as well as liquidity guarantees amounting to €145 billion for the banking group Hypo Real Estate.

The Commission concluded that the restructuring plan of HRE and its core bank pbb Deutsche Pfandbriefbank (pbb) is liable to restore pbb's long-term viability while ensuring that the bank and its former owners adequately contribute to the restructuring costs and that the distortions of competition created by the aid are mitigated. All business activities of the HRE group will be phased out, except for the activities of pbb. At the end of 2011, pbb's adjusted balance sheet size will be around 85% smaller than HRE group's balance sheet size at the end of 2008. This will adequately address the distortions of competition created by the massive state support received by the German banking group during the financial crisis.

Commission Vice President in charge of competition policy Joaquín Almunia said: "*Today's decision brings one of the most significant financial crisis state aid cases to a constructive close. HRE and its core bank pbb Deutsche Pfandbriefbank are significantly downsizing to limit the competition distortions caused by the huge state support they needed to survive the crisis. The restructuring plan seeks to ensure that the serious liquidity problems which threatened HRE's existence some years ago cannot be repeated, so as to ensure the future viability of pbb.*"

The cornerstones of the restructuring plan are:

- Only the core bank pbb will be active in the markets; with two strategic business lines: real estate finance and public investment finance, both targeting assets eligible for German covered bonds, either in the form of mortgage or of public sector bonds. All other activities, in particular budget finance, infrastructure finance, capital markets and asset management activities, will be phased out.
- The other main subsidiary of HRE Holding, DEPFA Bank plc., is to be run-down and will not generate any new business.
- Impaired assets transferred to HRE's winding-up institution FMS-WM (FMS Wertmanagement AöR) will be wound down.
- pbb's future activities are of considerably smaller scale than HRE's activities before the crisis, in terms of balance sheet size, volume of new business, workforce, branch network and geographical scope.
- pbb will carry out its activities based on a stable funding approach and improved internal control systems.

The Commission found the restructuring aid to be in line with its guidelines on restructuring aid for banks (see IP/09/1180) and its guidance for the treatment of impaired assets (see IP/09/322); subject to the implementation of the restructuring plan and the fulfilment of the commitments provided by Germany regarding HRE's restructuring.

Background

In September 2008, HRE faced a severe liquidity shortage after the interbank lending markets dried up in the aftermath of the Lehman Brothers bankruptcy. Subsequently, HRE benefitted from nearly €10 billion of capital from Germany (FMS-WM, the winding-up institution of HRE, is recipient of a part of that capital). In addition Germany provided liquidity guarantees of €145 billion. HRE also benefitted from an asset relief measure, provided by Germany, with an aid element of about €20 billion. HRE was nationalised by Germany in 2009.

On 1 April 2009, the German authorities notified the first version of the restructuring plan for HRE. On 7 May 2009, the Commission opened an in-depth investigation because it had doubts about the bank's viability and the adequacy of the measures aimed at burden sharing and minimising distortions of competition (see IP/09/712). The in-depth investigation was extended on 13 November 2009 (see IP/09/1708) and again on 24 September 2010 (see IP/10/1172), in order to cover additional aid measures.

The restructuring plan of 1 April 2009 was finally updated on 14 June 2011.

The non-confidential version of the decision will be made available under the case number SA.28264 in the State Aid Register on the DG Competition website once any confidentiality issues are resolved. New publications of State aid decisions on the internet and in the Official Journal are listed in the State Aid Weekly e-News.

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THEME: R2

Effectiveness of the supervisory practice (Central Bank, Financial Regulator and Department of Finance)

LINE OF INQUIRY: R2b

Nature and effectiveness of the operational implementation of the macro economic and prudential policy

Minister, for information
from John McCarthy
28th April 2009

ESRI Spring 2009 Quarterly Economic Commentary

Summary: the ESRI will publish revised economic forecasts tomorrow. GDP is projected to contract by 8.3 per cent (GNP by 9.2 per cent) this year. This is one of the most negative set of forecasts, although the projections are not dissimilar to the Departments forecasts which underpin the Budget. A further year of small negative growth is expected next year. The Institute make a number of comments on fiscal policy, most of which are positive. In relation to banking developments, the Institute indicate that it is too early to comment with certainty as to whether Government policy with respect to NAMA is appropriate. Finally, the need to improve competitiveness is highlighted.

The Economic and Social Research Institute (ESRI) spring 2009 Quarterly Economic Commentary will be published tomorrow, in time for the morning media. The Institute is forecasting that GDP will contract by 8.3 per cent (GNP by 9.2 per cent) this year. The GDP projection is not too dissimilar to our own (-7.7 per cent), while the GNP forecast is somewhat more pessimistic. The Institute is somewhat less negative than ourselves in terms of the outlook for next year.

Macro-Economic Forecasts (per cent growth rates unless otherwise stated)

	ESRI		Dept/Finance	
	2009	**2010**	**2009**	**2010**
GDP	-8.3	-1.1	-7.7	-2.9
GNP	-9.2	-1.2	-8.0	-2.8
Employment ('000)	-187	-103	-165	-89
Unemployment (rate)	13.2	16.8	12.6	15.5
CPI	-4.6	0.0	-3.9	0.3
GGB (per cent of GDP)	-12.0	-11.5	-10.7	-10.8

The Institute makes a number of observations regarding policy (a copy of the General Assessment is attached). The moves to address the deterioration in the public finances are broadly welcomed. The Institute sees the pension levy as preferable to a reduction in public sector numbers. The savings achieved through the February and April measures are seen as an appropriate balance between fiscal sustainability and the need to avoid over-deflating the economy. In terms of Budget 2010, the authors argue that less reliance on income taxes and greater emphasis on the expenditure side (through for instance lower land costs) is needed. In terms of specific taxation measures, they also anticipate that property and carbon taxes will be part of the 'solution' on the revenue side.

In relation to NAMA, while the Institute argues that the movement towards decisive action on the banking situation is a positive development, they note that further details will be needed in order to provide a more comprehensive assessment of the proposal. The Institute also argues that while nationalisation would ease concerns about pricing and would also be a speedy alternative, it is not without complications.

Finally, the Institute argues that tax and public sector wage policy can contribute to competitiveness and help ensure that Ireland is in a position to take advantage of the global economy when it recovers.

CC Secretary General, Mr. O'Brien, Mr. McNally, Mr. Cardiff, Mr. Connolly, Mr. McGrath, Mr. Gallagher, Mr. Higgins, Mr. Hogan, Mr. Carrigan, Ms. Cunningham, Mr. Dorgan, Ms. Herbert, Mr. Ahearne

Speaking Points (if required)

- For this year, the ESRI is forecasting that GDP will contract by 8.3 per cent (GNP by 9.2).

- My own Department is projecting a GDP decline of 7.7 per cent (GNP of 8.0 per cent) this year. So there is not a large difference.

- There is no question that we are in very difficult times and I am glad to see that the ESRI share the short-term analysis that I have been putting forward.

- I note that the ESRI acknowledges that the measures taken to ensure the sustainability of the public finances are appropriate. We have taken measures to maintain the public finances on a sustainable path while not deflating the economy too much and I am pleased that the ESRI recognises this. It was a difficult but important balance to achieve.

- In relation to 2010 I note what the ESRI have to say and once again I reiterate my view that the targets for correction must be seen as a maximum on the tax side and a minimum on the expenditure side.

- In relation to NAMA I note that the ESRI sees decisive action as a positive development, although they are awaiting further details before making a more definitive statement.

- There is much media debate proposing the nationalisation of Irish banks, particularly AIB and Bank of Ireland. The Government's strategy is to ensure that the lending needs of the real economy are met. A commercially focused banking system, which includes banks having a market presence, operating within market disciplines and constraints, is best equipped to achieve this aim.

Where banks are of systemic importance and viable in the long-term, they should be maintained as market listed plcs open to private investment.

- Internationally the prospect of wholesale nationalisation is very damaging to Ireland's reputation and attractiveness to international investors. No country is currently adopting a policy of wholesale bank nationalisation; there is no reason for Ireland to adopt such a policy.

Summary of the Central Bank Spring 2005 (Number 2) Bulletin

The Central Bank's Spring Bulletin was published today. The Bank expresses the view that economic prospects remain positive. Growth in line with potential is expected in 2005 and 2006, supported by a benign international environment. Inflation pressures remain subdued. However, risks, stemming from oil prices and exchange rate developments, are identified.

Economic Growth:

- The prospects for the domestic economy remain positive. Following the pick up in growth in 2004 (to 4.9% in GDP and 5.5% in GNP terms) continued growth at about the economy's potential is expected in 2005 and 2006. GDP growth is forecast to be 5.5% in 2005, GNP growth 5.25% - while in 2006 GDP growth is forecast to be 5.75%, GNP growth 5.5%.
- The Bank concludes that the external economic environment remains favourable, supporting growth in the Irish economy in 2005 and 2006.
- The Bank identifies oil prices and exchange rates as the two key sources of risk facing the economy. High oil prices (at present levels or possibly following further appreciation) have the potential to limit growth and increase uncertainty internationally and in Ireland. The Bank notes that it remains the case that a rapid appreciation of the euro is one of the most significant risks facing the economy. The Bank also draws attention to the fact that the economy's international competitiveness is significantly vulnerable to any further dollar depreciation.
- Along with other commentators the Bank expects the composition of growth to change somewhat in 2005 and 2006. Consumption growth is expected to pick up in 2005 and 2006 from the relatively subdued performance in 2004, aided by a strong labour market and disposable income growth. On the other hand investment growth is expected to be lower in 2005 and 2006 than in 2004, reflecting the fact that housing output levels are not expected to expand further from the present very high levels. The Bank believes that the outlook for exports in 2005 and 2006 is reasonably positive, with some pick up from the growth rate recorded in 2004. Import growth is also expected to increase, reflecting improved consumer and business/industrial demand.

Employment:

The Bank concludes that labour market developments remain very positive. The Bank expects that employment growth may ease back in 2005 and 2006, to 2.25% and 2% respectively, from 3% growth in 2004. However, labour force growth is expected to fall along with employment growth and as a result unemployment is expected to fall marginally to 4.25% in 2005, remaining at this level in 2006.

Inflation:

The Bank believes that "inflation pressures seem relatively subdued", and concludes that inflation is now in line with, indeed below according to recent indicators, that in the euro area. HICP inflation of 2% is expected in 2005 and 2006. CPI inflation of 2% in 2005 is forecast, with a pick up to 2.25% in 2006, reflecting the risk of a modest increase in inflation as the economy operates at full capacity.

House Prices:

The Bank concludes that there now appears to be clear evidence of a slowdown in the rate of increase in house prices. It believes that this is consistent with a soft landing in the housing market as supply and demand come more into balance.

Summary of Central Bank Forecasts:

	CENTRAL BANK		D/FINANCE*	
	2005	**2006**	**2005**	**2006**
GDP (%)	**5.5**	**5.75**	**5.1**	**5.2**
GNP (%)	**5.25**	**5.5**	**4.7**	**4.8**
Employment (%)	**2.25**	**2.0**	**1.9**	**1.5**
Unemployment (% Labour Force)	**4.25**	**4.25**	**4.4**	**4.5**
CPI (%)	**2.0**	**2.25**	**2.5**	**2.4**

***Budget Forecasts**

Cc. Secretary General, Mr. Sullivan, Mr. McNally, Mr. Moran, Press Office

Minister from D. Mulligan

<u>ESRI Budget Perspectives Conference 2003</u>

The ESRI's annual Budget Perspectives Conference takes place on Wednesday 2nd October, and the Conference papers will be published this morning. The aim of the Conference is to 'analyse and debate issues relating to taxation and public expenditure' and set the macroeconomic context for the forthcoming Budget. A number of papers will be discussed and the key points are summarised below.

- <u>The macroeconomic forecasts</u> underpinning the paper are GDP growth of <u>3.7</u> per cent in 2002 (GNP growth of <u>2.7</u> per cent). The ESRI forecasts are similar to our ERO 2002 forecasts of 3.6 per cent growth in GDP and 3.0 per cent growth in GNP. The ESRI forecasts GDP growth of <u>4.5</u> per cent in 2003 (<u>3.9</u> per cent GNP) [The Department is currently reviewing its economic forecasts, but they are likely to be lower than those of the ESRI]. Inflation is forecast to average 4.7 per cent in 2002 falling to 3.7 per cent in 2003.

  [We understand that these forecasts will be the ones published later this month by the ESRI as their Autumn Quarterly Commentary]. Unemployment is expected to rise to average 4.5 per cent in 2002 and 4.6 per cent in 2003.
- <u>Tax revenue</u> is forecast to grow by <u>5.3</u> per cent this year (implying a shortfall of over €900 million) with expenditure growth of 11½ per cent. It is estimated that the general government deficit in 2002 will be 0.4 per cent of GDP <u>(or €550m)</u>, growing to 0.6 per cent (or €783m) in 2003. These forecasts do not factor in the likely costs of fully implementing Benchmarking. The net impact would be around €700 million in 2003, with a knock-on impact from pressures of indexation of public sector pensions and social welfare payments to the higher rates of public sector pay. The following table sets out the state of the public finances as forecast by the ESRI.

	2002	2003
Tax Revenue (% change)	5.3%	7.5%
Total Expenditure (% change)	11.5%	10.1%
Exchequer Balance	-504	-3139
EBR as % of GNP	-0.5%	-2.8%
Gen Govt Balance	-550	-783
GGB as % GDP	-0.4%	-0.6%

- The appropriate response for fiscal policy is a broadly neutral stance given the slowdown in the domestic economy in the last year and the uncertainties with regard to the international outlook, as well as the fact that monetary conditions remain quite loose. A neutral stance would involve indexing of the tax and expenditure items to ensure no change in real terms when price and wage changes are accounted for.
- It is imperative that expenditure growth and tax revenue growth are brought into line in 2003. Greater focus should be placed on the General Government Balance as the use of funds from the broader government sector only flatters the Exchequer balance.
- Pressures on the public finances should not detract from the programme for national development. This will involve difficult choices between allocating scarce resources between current and capital expenditure. **The adoption of fixed expenditure rules that allow borrowing only for clearly defined investment purposes may be the best way to achieve this.**
- Both the short and medium term prospects for the Irish economy contain significant degrees of uncertainty for the likely state of the public finances. **Broadly speaking, however, there is a strong likelihood of a serious short-term deterioration in the budgetary position, while the medium term prospects remain broadly favourable provided that prudent control of the public finances is maintained.**

Regarding the issue of forecasting government revenue, the ESRI state that:

- Unanticipated changes in the inflation rate could have a significant impact on the public finances. For example higher inflation could lead to an unexpectedly large government surplus. A deflationary shock – which may come about through further appreciation of the euro, would lead to an unintended expansionary budget with a deteriorating budget balance.

- The difficulty in forecasting government revenues has increased in recent years due to a spate of significant tax changes and substantial budgetary system alterations. In 2001 the magnitudes of the two errors changed dramatically and the over-forecast of the unexplained component dominates the GDP element indicating that the under forecast of GDP was not the main cause of the error in forecasting tax revenue in that year.

The ESRI also look at the distributive impact of budgetary policy over the last twenty years, coming to the conclusion that during Ireland's recent growth spurt budgetary policy acted to reinforce income gains for the higher income groups, while involving losses for those in lower income groups**. However, covering the period of the last government (Budget 98 to Budget 02) no group made losses, although the top 60 per cent of the income distribution made substantial gains, with much more modest gains for the bottom income quintile.**

Speaking Points:

- I agree with the ESRI that the international economic environment is uncertain and that we have to recognise that our economy is slowing. We therefore need to tailor our expectations to the new reality. As I have said all along, if you do not have the money, you do not spend it.

- The macroeconomic forecast of 3.7 per cent growth in GDP this year is broadly in line with my own Department's mid year forecast of 3.6 per cent GDP growth. However, my Department is currently reappraising the overall economic and budgetary prospects on foot of the weaker than expected international economic prospects and the performance of tax revenues to date.

- I also agree that we must continue with the National Development Plan. Investing in the future is vital to ensure that we develop to our potential in the medium term.

Minister from Patrick Mullane
29th November 2005

OECD Autumn 2005 Economic Forecasts

The OECD published their Autumn forecasts today, Tuesday 29th November. The OECD stresses that for Ireland:

- **Domestic factors (household income gains and government spending) will drive growth in the forecast period 2005-2007.**

- **Rising unit labour costs are expected to hold back export growth.**

- **More intense competition is needed to provide a countervailing force to inflationary pressures in the short term and boost growth prospects in the long term.**

The key points from the OECD's forecasts are summarised below:

Ireland Outlook

- Real GDP is projected to grow at a steady 5 per cent over the period 2005-2007 with the main impetus coming from domestic demand.
- With strong activity exerting inflationary pressures, core inflation is likely to creep up over the period.
- The General Government balance is projected to record a deficit of -0.9 per cent of GDP this year and -0.6 per cent in 2006. The OECD suggests that a tighter fiscal stance would help to contain inflationary pressures and provide a buffer against adverse movements in the housing market or exchange rates.
- Unemployment is expected to average 4.3 per cent in 2005 and 4.2 per cent in 2006 and 2007.

Forecasts for Ireland	**Department of Finance**		**Commission**		**OECD**	
	2005°	2006*	2005	2006	2005	2006
GDP	5.1	5.2	4.4	4.8	5.1	5.0
Unemployment Rate	4.2	4.5	4.3	4.4	4.3	4.2
Inflation (HICP)	2.2	2.0	2.2	2.5	2.3	2.5
GG Deficit	-1	-0.6	-0.4	-0.3	-0.9	-0.6

° As per ERO

- As per Budget Day 2004.

World Economy Outlook

The OECD sees a good case for continued strong global growth over the forecast period. Despite higher oil prices, so far second round effects have not had a significant impact on long term inflation expectations or wage demands. The US and Asian economies are expected to continue to perform strongly as will oil exporting economies as they spend their oil revenues. The OECD forecast world trade will grow at around 7.1% this year and accelerate to over 9% during 2006-2007. In the *US*, growth is forecast to slow gradually from 3.6% in 2005 to 3.3% in 2007 and in *Japan* from 2.4% in 2005 to 2.0% in 2007. Growth in *China* is forecast to reach 9.3% in 2005 increasing slightly to 9.5% in 2007.

The consequence of continued strong growth is that the risks to the forecast are heightened, including
(1) renewed increases in oil prices
(2) the disorderly unwinding of growing global imbalances via exchange rate shocks,
(3) and an increase in long-term interest rates and a sharp fall in asset prices.

Euro area 2005-2007
Buoyant world growth should spill over into a stronger performance in the euro area. In the euro area growth is forecast to reach 1.4% in 2005, and accelerate to 2.1% in 2006 and 2.2% in 2007.
The OECD states that monetary policy should continue to accommodate growth in the euro area for some quarters more, at least until the recovery is more entrenched. The OECD also urges euro area governments to take advantage of the improved economic situation to press ahead with urgent fiscal consolidation and structural reforms.

Housing Paper

An OECD paper on house price fundamentals was also published today. Based on number of methodologies, Ireland is cited as one of a number of OECD countries where house prices are regarded as overvalued. However, the analysis does not appear to take some features of the situation here into account. Some speaking points on this paper are attached for information.

c.c Secretary General, Mr. Sullivan, Mr. McNally, Mr. Doyle, Mr. O'Gorman, Mr. Moran, Mr. Ó Murchadha, Mr. Hegarty, Press Office.

Speaking Points

- The OECD's forecasts are in line with my Departments Economic Review and Outlook forecasts, which were published in August. My Department will shortly publish updated forecasts as part of Budget 2006.

- Irish inflation has recently eased. However, we cannot afford to be complacent. Bringing the rate of inflation down further towards that of our EU partners remains a priority for the Government. This is essential in order to safeguard our competitiveness and prevent job losses.

- I share the OECD's concern in relation to the need to enhance productivity and efficiency across all sectors of the economy, in order to strengthen our competitive position. Competitiveness remains a priority for this government.

- I agree with the OECD that Ireland's medium term growth prospects remain good.

Housing Paper

- When looking at the housing market, it is important to recognise the substantial structural change which the Irish economy has undergone over the last decade. This may not be fully picked up in the cross country work of the OECD.

- I take the view – shared by most domestic commentators – that house prices in Ireland can be explained by a range of fundamental factors including demographic factors, large increases in employment and disposable incomes and low interest rates.

Minister,

From Sharon Daly

IMF: Report for the 2003 Article IV Consultation

Growth

The IMF forecasts have been revised downwards. GDP is now forecast to grow by 2½ per cent this year, while GNP is projected to rise by 1¼ per cent. These forecasts are based on estimated GDP growth of 6.3 per cent and GNP growth of 0.6 per cent in 2002, which have since been revised to GDP 6.9 per cent and GNP of 0.1 per cent. Activity is expected to pick up in 2004 provided the global economic recovery begins later this year and the euro does not continue to appreciate.

Employment

The IMF contend that any considerable increases in unemployment, more likely when the cap on public sector recruitment is implemented, may have a knock on effect on the housing market, which could postpone the pick up in activity.

Competitiveness

In relation to reduced competitiveness, it is noted that real wages may have to fall and that enhancing productivity and efficiency is important. This is particularly the case in the public sector where wages are rising due to the Benchmarking process.

Housing

After a sustained credit boom, there is a 'substantial' risk that house prices are overvalued. The IMF recommends that frequent policy reversals (which would lead to market volatility) and any measures which would postpone the adjustment of house prices (as this could lead to a sharper decline later) be avoided.

Inflation

The IMF note that inflation remains higher in Ireland than the euro area average. They attribute part of the differential to temporary, specific factors, particularly **indirect taxes in 2002**. However, they also note that there is broad agreement that inflationary pressures would subside in 2003/ 2004.

The IMF argues that the government's fiscal stance for 2003 is appropriate. This stance, it is argued, makes reasonable progress towards the medium-term fiscal target. Public current expenditure is best restrained through increased efficiency rather than tax increases.

Summary of IMF Forecasts:

	2003	2004
GDP, per cent	2.5	3.8
GNP, per cent	1.3	3.1
Employment, per cent	0.8	1.1
Unemployment, per cent	5.3	5.6
HICP, per cent	4.1	2.6

Speaking Points

- The IMF has revised downwards its forecasts for GDP and GNP growth to 2½ per cent and 1¼ per cent respectively for 2003. My Department will, as usual, publish updated forecasts in the Economic Outlook and Review in the summer.

- I note that the IMF believes that the fiscal policy this government is pursuing for 2003 is appropriate both for the short and medium term. I agree with the IMF that control of public expenditure is important.

- I share the IMF's concern in relation to the need to enhance productivity and efficiency across all sectors of the economy, in order to strengthen our competitive position. Competitiveness remains a priority for this government.

- I would not agree with the IMF's assertion that there is a significant risk that house prices are overvalued. The housing market is based on sound fundamentals with an estimated 1.5 million people aged between 15 and 34, demand for housing should continue to be strong over the medium term.

- I am confident that if we manage our economy and public finance prudently and focus on our competitiveness, we will be well placed to benefit from the international recovery when it occurs.

Minister from Sharon Daly
26th November 2003

OECD Autumn 2003 Economic Forecasts

The OECD published their Autumn forecasts today, Wednesday 26th November. The OECD stress that for Ireland:

- **In order to contain inflationary pressures, competition and regulatory policy should focus on the sheltered sectors (notably construction and business services).**

- **Tax incentives that boost demand for housing in an already overheated residential market should be cut, which would also enable resources to be reallocated towards urgently needed infrastructure development.**

The key points from the OECD's forecasts are summarised below:

Ireland: Key Projections

- After unexpected resilience in 2002 real GDP is expected to slow to 1.8 per cent in 2003, before rebounding to 3.6 per cent in 2004, as a result of the strengthening export market.

- Inflation is forecast to follow a downward trend whilst remaining above the European Union average, reflecting persistent price pressures in the service sector. HICP inflation is projected to average 4.1 per cent this year and 2.8 per cent in 2004. This is broadly in line with our own ERO and Budget Day 2003 inflation forecasts.

- The General Government balance is expected to record a deficit of –1 per cent of GDP this year and -1.3 per cent in 2004. These forecasts are almost identical to our September Maastricht returns for 2003 and Budget Day 2003 Forecast.

- Unemployment is expected to average 4.8 per cent in 2003 and 5 per cent in 2004.

International Economy: Key Projections

- In the euro area, real GDP is expected to grow by 0.5 per cent in 2003. By 2004 the full effects of the international recovery will have taken hold and this is reflected in a GDP growth figure of 1.8 per cent. Growth of 0.7 per cent is forecast for the EU this year, followed by a growth rate of 1.9 per cent in 2004.

- Growth in the US is also expected to recover in 2004. Real GDP is expected to grow by 2.9 per cent in 2003 and 4.2 per cent in 2004. In Japan real GDP is expected to grow after two successive years of contraction. The OECD forecast 2.7 in 2003 and 1.8 per cent in 2004.

Forecasts for Ireland	**Department of Finance**		**Commission**		**OECD**	
	2003°	2004*	2003	2004	2003	2004
GDP	1.5	4.1	3.3	4.5	1.8	3.6
Unemployment Rate	5.2	5.3	5.6	5.6	4.8	5.0
Inflation (HICP)	4	3.0	4.2	3.2	4.1	2.8
GG Deficit	-0.9^	-1.2	-0.6	-0.9	-1	-1.3

° As per ERO

* As per Budget Day 2003.
  2004 General Government Deficit excludes contingency provision.

^ As per September 2003 Maastricht returns

c.c Secretary General, E. O'Sullivan, D. McNally, D. Doyle, N. O'Gorman, Derek Moran, Dermot Mulligan, Press Office.

Speaking Points

- The OECD's forecasts are in line with my Departments Economic Review and Outlook forecasts, which were published in August. My Department will shortly publish updated forecasts as part of Budget 2004.

- With regard to investment, the Government is committed to tackling Ireland's infrastructural deficit. Since 1997 the Exchequer has invested over €3.3 billion in capital expenditure. The Exchequer provision is now close to 5 per cent of GNP as compared with 3.4 per cent in 1997, which is twice the EU average.

- I agree with the OECD's assessment that the Irish inflation will continue to ease towards the medium term. However, we cannot afford to be complacent. Bringing the rate of inflation down further towards that of our EU partners remains a priority for the Government. This is essential in order to safeguard our competitiveness and prevent job losses.

- Keeping public expenditure on target will be important if our inflation rate is to continue to moderate. New management and control mechanisms have been put in place to this end.

- I share the OECD's concern in relation to the need to enhance productivity and efficiency across all sectors of the economy, in order to strengthen our competitive position. Competitiveness remains a priority for this government.

- I agree with the OECD that Ireland's medium term growth prospects remain good.

Minister

20th December, 2004

Sharon Daly

Cc. Secretary General, D. McNally, D. Moran, Barra O'Murchadha, Press Office

ESRI Quarterly Economic Commentary

A press conference took place today to launch the ESRI's Quarterly Economic Commentary (QEC) which will be published tomorrow, December 21st. The main points are summarised below.

Impact of Budget 2005

The ESRI have a special article in the QEC called: 'Budget 2005: Impact on Income Distribution and Relative Income Poverty'. In this analysis the ESRI conclude that Budget 2005 was progressive in that it favoured low income groups with smaller gains for those on higher incomes. Gains for the bottom quarter of income earners were in the order of four per cent compared with less than one per cent for the top quarter of earners.

Housing Output

The ESRI have highlighted the Irish economy's exposure to the high volume of house building. They estimate that house building contributed 1 per cent to GDP growth in both 2003 and 2004. The ESRI state that at some point housing supply will decline to an estimated 30,000 compared with around 80,000 units in 2004.

For the purpose of illustrating the importance of housing construction to the Irish economy they model a fall in housing supply by 50 per cent to 40,000 units in one year. They estimate that this would reduce GNP by 3 per cent in the short term. However, they point out that this is not a forecast outcome; they do not think that this scenario is likely to happen and are predicting a relatively soft landing for the housing market with a small decline in the order of 5 per cent in 2005. It can be anticipated that this item will draw media attention.

Economic Growth rates for 2004 revised upwards and for 2005 revised downwards

The ESRI have revised their 2004 economic growth projections upwards in light of the robust performance of the Irish economy observed in the first half of this year. The ESRI now expect GDP growth for Ireland of 5.5 per cent in 2004, with GNP growth of 5.1 per cent, up from 5.2 per cent and 4.8 per cent for GDP and GNP respectively in the Autumn Commentary. The 2005 figures have been revised downwards somewhat on the basis that the recovery in the international economy is expected to continue at a more subdued pace in 2005 and a forecast reduction in housing output. For 2005, GDP and GNP growth rates are expected to be 5.0 and 4.6 per cent respectively, down from 5.4 per cent and 5.0 per cent for GDP and GNP as published in the Autumn Commentary.

These revised forecasts are very close to the 5.1 per cent and 4.7 per cent for 2005 as published by the Department on Budget Day.

Good Employment Prospects in 2004 and 2005

The ESRI project a steady rate of employment growth over their forecast period. They have revised up their employment growth forecast for 2004 to 2.6 per cent, up from 2.3 per cent in the Autumn Commentary. In 2005 employment growth is expected to moderate somewhat to 2.0 per cent. They forecast a corresponding fall in the unemployment rate to 4.4 per cent in 2004 and 4.3 per cent in 2005.

The ESRI anticipate that employment in the services sector will continue to drive employment growth, although industry is likely to make a stronger contribution to employment than it did in 2003.

Inflation set to moderate between 2004 and 2005

The ESRI expect inflation as measured by the CPI to be about 2.2 per cent in 2004, falling to 2.1 per cent in 2005. This is the most optimistic forecast for inflation in 2005. This constitutes a downward revision of their 2005 forecast from the Autumn Bulletin from 2.4 per cent. The ESRI expect the euro to remain strong in 2005 which would put downward pressure on import prices, they also expect oil prices to fall back and do not now expect an interest rate increase until the second half of the year. This coupled with the absence of changes to indirect taxes in the recent Budget has resulted in the downward revision of their 2005 CPI forecast.

Public Finances

The ESRI comment that the public finances are in a very strong position boosted by the strength of economic activity and a series of tax windfalls from on-going revenue investigations. They forecast a General Government Balance of 1.1 per cent of GDP in 2004 and -0.6 per cent in 2005. They believe that the Budget will provide a strong fiscal stimulus in 2005 in a situation where the economy is growing at its potential. However, they argue that this may not be inappropriate given the potential downside risks to their forecasts over the next few years.

Comparison of Forecasts

	2004		2005	
	Dept. of Finance Dec. '04	ESRI Dec. '04	Dept. of Finance Dec. '04	ESRI Dec. '04
GDP	5.3	5.5	5.1	5.0
GNP	4.9	5.1	4.7	4.6
Inflation (CPI)	2.2	2.2	2.5	2.1
Unemployment Rate	4.5	4.4	4.4	4.3
GGB (% GDP)	0.9	1.1	-0.8	-0.6

Speaking Points

- I am pleased to see and obviously agree with the ESRI assessment that the Budget was progressive in terms of the direction of tax and social welfare measures in favour of those on lower incomes – it was a key objective of the Budget.

- The ESRI forecasts for economic growth in 2004 of 5.5 per cent and 5.1 per cent in GDP and GNP terms respectively which are in line with my own Departments forecasts as published on Budget Day.

- The ESRI's economic growth forecasts for next year of 5.0 per cent in GDP terms, and 4.6 per cent in GNP terms, are also in line with my own Departments forecasts for 2005, which were published at Budget time.

- On Budget Day my Department forecast CPI inflation of 2.2 per cent this year. The ESRI are of the same view.

- The Government is committed to the EU Stability and Growth Pact requirement of keeping the Government finances at close to balance or in surplus. This is the overriding framework for our budgetary policy, as set out in the Programme for Government.

- I note the ESRI's modelled 50 per cent fall in housing output. It is important to emphasise that this is <u>not</u> the ESRI's forecast for housing nor do they view it as likely to happen. It is simply an illustration of the importance of housing output on the economy. It is illustrative and doesn't take account of potential dynamic effects or policy responses.

Statement of John Moran, Secretary General (2012-2014)

Dear Members of the Committee

I joined the Central Bank only in July 2010 to restore credibility to Ireland's supervision of wholesale banks, becoming more centrally involved only in 2011 when appointed Head of Banking Policy and Restructuring and later (2012) Secretary General of the Department. For that reason, I confine my observations to matters arising after 2010.

I have been directed to make a written submission on nearly 20 diverse topics of inquiry. It would not have been possible given the restrictive word count to do justice to each. So, rather than provide short (and probably not so instructive) text for each topic, I have taken the liberty to make more general observations pertinent to the range of items.

My observations are presented under the following headings:-

- Ireland's crisis was not just a banking problem but very much a fiscal one
- Burning the bond-holders - not the silver bullet solution
- The civil service and the political process
- The Department's relationships with the NTMA and the Central Bank
- Other changes made in the Department during my three years there.

A Our crisis was not just a banking problem but very much a fiscal one

Some people like watching thriller TV programmes or movies, accustomed to plots with high-suspense and goodies or baddies. They might wish for the drama of Ireland's economic collapse to be couched in terms of irresponsible over-paid bankers, reckless developers, the night of the bank guarantee, and the burning of these faceless bondholders. It makes good TV as they say!

A simplistic rhetoric has therefore been entertained that if we had not had a collapse of Lehman Brothers and the Irish banks and had burned the bondholders, we would have had no issues.

True, our property price collapse led to awful widespread destruction of personal wealth and unemployment.

But the sad reality is that an acute lack of fiscal capacity at Governmental level removed flexibility in easing the impact of those problems. The fiscal rectitude we are experiencing since, was a necessary result of the terrible and perilous structure of Ireland's fiscal profit and loss (or if you like taxes and spending). That P&L collapsed causing recurring deficits to be painfully funded by piling yet more debt onto the back of future generations. As we come out of this crisis, this debt will end up being be more than twice the net debt expected from the bailout of the banks.

This all should not be forgotten.

Annual current spending (sadly, recurring) and reductions (again, recurring) in the annual taxation burden had been set at levels out of all appropriate relationship with the quantum of sustainable revenues of the state in the early years of the 21st Century.

Budgetary spending decisions had been funded in the years leading up to the crisis from what were very fragile revenue sources, built on the quicksand of an economic performance overly

EPD012/035/02/PART 003.

Draft

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Minutes of MAC Meeting 26 April 2001

Apologies: *Donal McNally, Joe McGovern and Michael Scanlan*

Agenda Item 1 : Minutes of 19 April and Matters Arising
The minutes were agreed subject to the following amendment to Agenda item 2 - deletion of the second sentence and amendment of the last sentence to read: "It was agreed that Mr McNally and Mr Doyle would prepare a paper for the Government on the BEPGs, conveying the current trends in expenditure and taxation, as well as the prospects for the economy". There were no matters arising.

Agenda Item 2 : Update on Expenditure, Taxation and Pay
Mr Doyle gave an update on expenditure while Mr Considine outlined recent developments with pay. He noted that the CPSU were going to ballot on industrial action and this was a cause of concern. An Aide Memoire on pay had been prepared for the Government, as agreed at the last meeting.

It was agreed that the Budget Co-ordination Group would discuss the various issues which need to be covered in the paper to be drafted on the BEPGs.

Agenda Item 3: Group on Recruitment and Retention
There was a detailed discussion on the paper. The MAC welcomed the paper and noted that many of the proposals had service wide implications and would need to be addressed centrally. The main proposals in the paper were agreed, subject to the following amendments:

Proposal A - the aim should be to attract specialists and generalist graduates in the ratio 50:50

Proposal B: it was the MAC's view that the level of sponsorship proposed for undergraduates was on the low side; that undergraduates should be targeted in their penultimate year of study; and that the minimum period of commitment to the civil service should be two years. It was agreed that the proposal could be put on the agenda for the Secretaries' Conference.

Proposal E: while the MAC agreed with the suggestion that some measure of recruitment should take place above AO level, it recognised the difficulties involved with such a proposal. CSD are to explore the possibilities in relation to the recruitment of specialists for the Department.

Proposal J: in areas where the Department has a deficit of skills, it should seek inward secondments of suitably qualified staff from bodies/employers with the relevant expertise.

Proposal P: this should not be confined to AOs and HEOs but should also cover junior APs. It was accepted that the need for policy analysis training was a service wide issue and it was agreed that Eric Embleton would prepare a paper on the issue.

CSD are to keep the MAC informed of developments with the proposals and it was agreed that Recruitment & Retention would be revisited by the MAC on a regular basis.

Agenda Item 4: **Agenda Item 4 : A.O.B.**
There were no items discussed under this heading.

Agenda Item 7: Next Meetings:
- Friday 27 April (10 am SMI Review - Colm Gallagher)
- Friday 4 May (2.30 pm)
- Friday 11 May (10.30 SMI Review- Michael Scanlan)
- Tuesday 22 May (11 am)
- Thursday 24 May (8.45 am - Ministerial MAC)

Minutes of MAC meeting on 31 March 2008

Attendance: Secretary General, Secretary General PSMD, Donal McNally, Kevin Cardiff, William Beausang, Jim Duffy, Colm Gallagher, Michael McGrath, Ann Nolan, John O'Connell, Stephen O'Sullivan, Des O'Leary.

Apologies: Jim O'Brien,

Agenda item 1 - minutes of previous meeting and matters arising
The minutes of the previous meeting were approved. There were no matters arising

Agenda item 2 – End March fiscal position and statements re budgetary and economic outlook
The tax and expenditure position for the first quarter and projections for the rest of the year were discussed. Ms Nolan said that expenditure to date was broadly on target but strong upward pressures existed. Mr McGrath indicated that there were significant shortfalls in CGT and VAT receipts.

Agenda item 3 – Preliminary schedule for '09 BSM
A draft schedule was discussed. It was agreed that the issue be kept under review and that developments in the Pay talks be taken into account.

Agenda item 4 – Departments responses on Efficiency Reviews
The meeting noted that the levels of savings proposed to date by Departments was disappointing. The need for Agencies to make more effective contributions to the review process was also noted. Mr O'Leary indicated that developments on the Departments A1 subhead may have implications for the timing of vacancy filling during the year.

Agenda item 5 – Financial markets
Mr Cardiff briefed the meeting. It was noted that market movements had been volatile in the preceding week and that financial service companies position on funding had become more restrictive.

Agenda item 6 – PSMD issues
Mr Connolly briefed the meeting. The ICTU conference is scheduled for 17 April. The Pay talks would be expected to commence shortly thereafter. He also reported on industrial relations issues, with particular reference to the Health Sector, and on development in relation to decentralisation. The current situation on the OECD review was also discussed. He emphasised the need for early filling of the Head of IT Unit within the Department.

Agenda item 7 – Other issues
The current situation on a range of issues was discussed; PMDS, E-payments, Long-term issues report, accommodation, the REACH project, Social Partnership, the Pensions White Paper and the Procurement Unit. It was agreed that the Pensions White Paper would be discussed further at the next MAC.

Minutes of MAC meeting on 14 April 2008

Attendance: Secretary General, Secretary General PSMD, Jim O'Brien, Donal McNally, Jim Duffy, Michael McGrath, Robert Watt, Derek Moran, Ann Nolan, Judith Brady.

Apologies: Kevin Cardiff, William Beausang, Colm Gallagher, Eamonn Kearns

Agenda item 1 - minutes of previous meeting and matters arising
The minutes of the previous meeting were approved, subject to minor amendment.

Agenda item 2 – Long Term Issues Report
Ms Nolan introduced the report 'Sustainability of Ireland's Public Finances – Opportunities and Challenges'. There was a round table discussion on the substance of the major issues arising in the report, together with the question of presentation.

Agenda item 3 – SPD issues
Mr McNally briefed the meeting in relation a number of issues including the Efficiency Review, the Long Term Issues Report - a separate agenda item, university pensions, emerging expenditure developments, climate change, election expenses, Greenmount archaeological site, Dublin Port, dividend policy for SSBs, PPPs and unitary payments, VFM reviews and ODA management.

Agenda item 4 – Efficiency Review
The Secretary General requested CSD to submit a report to the next MAC meeting on the issues in the Review which were recommended for implementation.

Agenda item 5 – Safety Statement
The Secretary General advised the Statement would be revisited at the next MAC meeting and that the Head of CSD should sign off on the Statement.

Agenda item 6 – Update on Economic Developments
Mr McGrath updated the meeting in relation to the recent IMF forecasts and advised that the Commission's forecasts were due in the next couple of weeks. On the domestic side, Mr McGrath referred to the March inflation figure of 5%, manufacturing outputs and housing projections. There was a short discussion on the housing related aspects of the IMF report and the Secretary General requested a report from the Irish Representative at the IMF on this issue.

Agenda item 7 – Monthly Financial Report
The Report was noted. The Secretary General requested that the April report outline the approach being taken to prevent any potential excess on the Vote.

A.O.B.
Secretary General PSMD, who then chaired the meeting as the Secretary General had to leave, advised that a vacancy was arising on the board of FAS and requested nominations at PO level, which did not give rise to any conflict of interest.

Action points

- CSD to report back to MAC on the Efficiency Review and the Safety Statement and, in the April Monthly Financial Report, on the approach to potential excess expenditure.
- Nominations for board of FAS at PO level to Secretary General PSMD.

Next meeting: Monday, 21 April @ 11am

Minutes of MAC meeting on 9 June 2008

Attendance: Secretary General, Secretary General PSMD, Kevin Cardiff, Jim O'Brien, Donal McNally, William Beausang, Colm Gallagher, Ann Nolan, Michael McGrath, John O'Connell, Judith Brady.

Agenda item 1 - minutes of previous meeting and matters arising
The minutes of the previous meeting were approved, with minor amendments. Matters arising related to the Budget Strategy Memorandum, a redraft of which would be available for Tuesday 10th, based on receipts of obs by close of play Monday 9th 2008. Mr McGrath outlined the issues involved, which were discussed by the meeting. It was agreed that there would be a two step approach to the BSM in terms of initially outlining the scale of the adjustment required, followed by specific proposals which would reflect a mix of considerations in terms of taxation and current and capital spending. It was also agreed that a meeting would be arranged to brief the POs and APs on the tax and spending side in relation to relevant developments. The discussion also included the issue of briefing the social partners and Dáil consideration.

Agenda item 2 – BEPD Issues
Mr O'Brien briefed the meeting on European issues, including the special seminar on Ireland on 27 June, involving public and private sector participants; the EU Budget Review and the extended deadline for submissions, in which regard the memorandum for Government on Ireland's submission would be submitted shortly; the EU Budget Council meeting on 17 July. Mr O'Brien also provided an update on the Green Paper on Pension, with a July date for probable submission to Government; the Protection Fund; Structural Funds closure; North/South Bodies; Public Financial Procedures; the Better Financial Reporting Group; National Pension Reserve Fund and the draft Finance Accounts. On the international level, Mr O'Brien referred to the forthcoming meeting in Korea and the advisory positions arising in the World Bank and the IMF.

Agenda item 3 – Long Term Issues report penultimate draft
Ms Nolan updated the meeting. The draft is to be available on Friday 13 June.

Agenda item 4 – Decentralisation
There was a short discussion in relation to a Min/MAC meeting on decentralisation, which is to be arranged by CSD. Áine Stapleton is to prepare a paper on the Finance aspects and attend.

Agenda item 5 – AOB
CSD were asked to prepare a paper on the logistics of the moves between Hatch Street, Merrion Row and South Block.

Action points

- Redraft of BSM for Tuesday 10th, - Michael McGrath.
- Meeting to brief the POs and APs on tax and spending side – Ann Nolan and Michael McGrath
- Long Term Issues report draft for Friday 13th - Ann Nolan
- Finance Accounts for signature by end month – Jim O'Brien
- Paper on accommodation logistics – Judith Brady
- Arrange Min/MAC on decentralisation – Judith Brady.

Next meeting: Monday, 16 June @ 11am

Minutes of MAC meeting on 3 November 2008

Attendance: Secretary General PSMD, Kevin Cardiff, Donal McNally, Jim O'Brien, David Moloney, Robert Watt , Patricia Coleman, Des O'Leary

Apologies: Secretary General, William Beausang

Agenda item 1 - minutes of previous meeting and matters arising
The minutes of the previous meeting were approved subject to minor amendment. No matters arose.

Agenda item 2 – Pension funding issues
The meeting considered a range of issues which could arise in the event of the emergence of financing difficulties in defined benefit pensions schemes. The primary responsibility of the Pensions Board and of the Department of Social and Family Affairs in relation to scheme structures and regulatory issues was noted.

Agenda item 3 – PSMD issues
The Secretary General PSMD briefed the meeting on a range of issues including public service pensions in the context of the Green Paper, the process of ratification of the Pay Agreement, the Task Force on the public service, agency rationalisation and decentralisation.

Agenda item 4 – Risk Management
The meeting considered the 2008 Risk Management Strategy submitted to it by the Assistant Secretary Group. It was agreed to refer the document back to the ASG for further consideration in the light of recent changes in the Department structure and the emerging financial situation. The meeting also agreed that the issue of risk management should be addressed on a quarterly basis by the MAC.

Agenda item 5 – Special service payments
The meeting approved the recommendations of the Assistant Secretary Group subject to the exclusion of one applicant who was already in receipt of a substantial allowance in respect of the post held by that officer.

AOB -
The meeting was informed of the Secretary General's proposal for sequential reviews of expenditure throughout 2009.

Next meeting: Monday 10 November @ 11a.m.

Minutes of MAC meeting on 17 November 2008

Attendance: Secretary General PSMD (chair), Kevin Cardiff, Donal McNally, Jim O'Brien, William Beausang, David Moloney, Robert Watt , Patricia Coleman, Des O'Leary

Apologies: Secretary General

Agenda item 1 - minutes of previous meeting and matters arising
The minutes of the previous meeting were approved. It was noted that a meeting was scheduled for later in the day in the Department of the Taoiseach in relation to the proposed Programme for Strategic Recovery.

Agenda item 2 – SPD issues
Mr McNally briefed the meeting. He referred to the current position in relation to the VHI and risk equalisation and specifically timing issues regarding the process of notification of the EU Commission. The membership of the proposed Expenditure Review Group remains to be finalised with the Minister. It was agreed that the emerging issues on defined benefit pensions schemes, PPP funding and 2009 local government funding should be included on the Government early warning list. The method of processing Bills on amalgamation of Agencies through the Houses, e.g by grouping those where common themes emerge, was considered. Reference was also made to a recently received proposal from the Department of Arts, Sport and Tourism regarding the Waterford Crystal visitor site. The meeting also noted that changes in accountancy rules may require data on NORA to be reflected in the national debt calculations.

Agenda item 3 – Monthly Financial Report
The meeting noted the contents of the Report.

AOB –
No issues arose

Next meeting: Monday 24 November @ 11a.m.

Minutes of MAC meeting on 24 November 2008

Attendance: Secretary General, Secretary General PSMD, Kevin Cardiff, Donal McNally, Jim O'Brien, William Beausang, David Moloney, Robert Watt , Patricia Coleman, Judith Brady.

Agenda item 1 - minutes of previous meeting and matters arising
The minutes of the previous meeting were approved. There was a brief discussion on the Waterford Crystal visitor site.

The Secretary General indicated that he was adding some further items to the agenda – business lending, pensions and the expert committee on public expenditure. The Secretary General indicated that in relation to business lending an update was required for the Taoiseach in the context of the forthcoming meeting with performance agencies. A memorandum for Government on stabilising the banking sector, drawing on the results of the meeting, was also required. The discussion also referred to credit insurance. There was a short discussion on developments in relation to pensions and on the composition and secretariat of the committee of experts which was being appointed to review aspects of public expenditure.

Agenda item 2 – BTED issues
Mr O'Brien briefed the meeting. He referred to the current developments in relation to EU fiscal stimulus and the draft Commission document. Mr O'Brien advised that the Stability and Growth pact still applied with the understanding that timeframe for compliance would be extended. Briefing on this matter was requested for the Minister and briefing is also being prepared for the Taoiseach in the context of visits with the heads of state of Sweden and Finland. The Secretary General also requested a note on the British pre-Budget Report. Mr O'Brien provided an update on the Finance Bill, the inter-agency group on taxation, the NPRF and a note for the Minister on the review conducted by Maurice O'Connell. Mr O'Brien also advised regarding the economic outlook that there was a separate note for the Minster on tax intake. It was noted that supplementary estimates, consistent with the Budget, would be taken this week.

Agenda item 3 – Banking Sector
Mr Cardiff outlined developments in the banking sector, including the Minister's meeting with the banks last Friday and the feedback requested from the banks in relation to their strengths and weaknesses. Mr Cardiff advised that the approach being taken in this sector was to keep the usage of state money to a minimum. Mr Cardiff provided an update on the bank guarantee arrangements and there was a discussion on the regulatory system. The Minister will write to the Financial Regulator in relation to progress on staff expansion in the context of the bank guarantee regulatory arrangements.

Agenda item 4 – Economic recovery
There was a discussion on the paper circulated by the Department of the Taoiseach and the Department of Finance report to the cabinet sub-committee on economic recovery. Further developments are awaited and the evaluation and comment will be provided, if required.

Agenda item 5 – VFM report period ending 30th June 2008
There was a brief discussion on this matter and a decision to defer to next week's meeting.

Agenda item - Suspense Account Report
The report was noted and the Secretary General requested that the Finance Unit prepare an office notice for him in the context of the review of the suspense accounts outlining the correct procedures for the management of the accounts and any relevant issues which arose during the review.

AOB –
There was a short discussion on the Minister's forthcoming address to IBEC and a brief summary of the programme of work to end of the year.

Next meeting: Monday 1 December @ 11a.m.

Minutes of MAC Meeting on 4 December 2006

Attendance: Secretary General, Donal McNally, Jim O'Brien, Kevin Cardiff, John O'Connell, Aidan Dunning, Jim Duffy.

Apologies: Secretary General PSMD, William Beausang, Michael Errity.

Agenda Item 1: Approval of draft minutes of 27 November, matters arising

The draft minutes were approved. There were no matters arising.

Agenda Item 2: Budget 2006 – Tax and Spending Outturn

Mr. McNally reported on overall tax receipts at end-November which were significantly ahead of target at 16 per cent above the 2005 yield. He noted that increases in capital gains tax and stamp duties had contributed very significantly to this increase. He said that an Expert Group was being established to evaluate tax forecasting methodology. The MAC agreed that a statement formally setting up the Group should be drawn up by BED. No significant changes were reported on expenditure.

Agenda Item 3: Budget 2007

Mr. McNally updated on ongoing preparation for Budget 2007. He noted that Budget Day briefing for Cabinet was scheduled for 9 a.m. on 6 December. Mr. Dunning referred to issues arising in connection with Capital carryovers.

Agenda Item 4: National Development Plan

Mr. Dunning updated on the NDP and noted that the Memorandum for Government on the Multi-annual Capital Envelope 2007-2013 had been approved by Government subject to certain caveats. The Memorandum for Government with the full text of the NDP has been submitted and a Government decision would be sought on 12 December to facilitate final drafting and translation prior to publication in January.

Agenda Item 5: A.O.B.

The MAC noted the attached paper from CSD concerning the DIG's approval, in principle, for CMOD (ICT Policy and Control Units) to decentralise to the Millennium Business Park, Naas, on an interim basis and as a stand alone unit,

Review of Department: Panel Meetings of 11-15 October, 2010

Monday, 11th October

Session I: **Organisation of the Department – Present position and way forward, Derek Moran**
Attended by: Ciarán Connolly (SG PSMD), Brendan Duffy, Michael Errity and Tim Duggan

Mr. Moran outlined his personal views on the organisation of the Department, with reference to the Review of the mid-1990s, the attitudinal survey carried out in 2002 and the Capacity Review published in 2008.

The main points made were as follows:

- Mr. Moran and Mr. Connolly confirmed that, while there may be an awareness of poor management in the Department, there is no on-going monitoring of staff management skills and such skills are discussed when a related problem arises. It was also noted that, as the Department is task driven, there is a tendency to give work to those who will deliver on the task.

- In response, Mr. Wright noted that the importance of monitoring people management skills, stating that, if you measure it, it matters.

- Mr. Moran also noted that the Secretary General has a corporate role, but that sometimes it can be difficult to detach from policy work. There should be some rethinking on the role of Heads of Division. This had been looked at in the Capacity Review and the view was taken that the role of Heads of Division should be considered. However, when a vacancy arose in FSD on the promotion of the current Secretary General, the decision was taken to fill the post, reflecting the span of responsibilities of the Department.

- Mr. Moran raised a number of issues with regard to the numbers of Assistant Secretaries:
  - If there are a large number of Assistant Secretaries in a small Department, there is less need to delegate work downwards, which can lead to A/Secs taking on less of a management role and capacity building in the Division. Poor delegation can also lead to decision making being pushed up the line.
  - The number of Assistant Secretaries necessitates rotation of attendance at MAC meetings.

- It was noted that there are a number of groups at Assistant Secretary level in the Department to deal with cross-cutting issues, e.g. the Budget Coordination Group and Social Partnership Group.

- Mr. Moran proposed that the Executive Office, which currently provides a support function to the Secretary General should be strengthened in order to give increased authority to the strategic planning process. Mr. Malone suggested that an alternative to this course could be the appointment of a strong Head of Corporate Affairs who would act as a link between the Secretary General and

Management, the Minister's Office and the Press Office.

- With regard to the "cell based structure" in the Department, it was noted that, while this structure can be very effective in achieving results, it mitigates against a team-based approach. The open plan layout of some buildings facilitates greater interaction between staff; however such a layout would not be possible in the Merrion St. building.

- Mr. Moran proposed that a unit including economist, statistician and other required skills should be established to deal with horizontal issues. He stated that there is not need for professional streams; these would create IR problems and there would be no career path for them to follow.

- Mr. Connolly noted that there is greater flexibility now to bring in specialists to meet particular requirements – this was possible before the Croke Park deal was agreed. He noted that all competitions from PO level upwards are open. Competitions for IT related posts are advertised across Departments. There have been a number of open TLAC competitions but these have had a low number of applicants from outside.

- Mr. Connolly described recruitment process in the Civil Service and undertook to provide a note to the Panel on the matter.

- There was a discussion on the options available to regularise those people taken in to the Department through secondment.

- In response to a question from the Panel, Mr. Connolly advised that there are no impediments to recruiting economists, if this is required. However, current budget constraints may make this difficult. In this context, the Panel requested a paper on the Department budget.

X

- Mr. Connolly advised the Panel that, while the Cabinet Sub-Committee on TPS is chaired by the Taoiseach most of the statutory functions of the TPS agenda lie with the Department of Finance and that the Department had increases its role in a range of TPS related areas over the past few years. He also provided the background information on the stages of reform in the public sector, from the establishment of the Department of Public Service to the Croke Park. He noted that overall the public sector is quite efficient and that the size of the sector is appropriate to the size of the economy – this was borne out in the OECD Report on the Irish Public Sector. It was noted that the Department of Finance agreed with many of the recommendations made in this Report.

- Mr. Connolly outlined a number of initiatives currently underway under the TPS process, including establishment of a Senior Public Service and shared services projects.

- With regard to the Croke Park Agreement, Mr. Connolly stated that, while IR issues generally and the Croke Park Agreement specifically pervades much of what the PSMD does, the reform measures agreed to in it are more relevant to operational Departments such as Agriculture, Health etc., than policy Departments like Finance. One of the main benefits that Croke Park will bring is flexibility. Underperformance will also be dealt with under Croke Park – this was put on the agenda by the Civil Service management. Mr. Duggan noted that the Croke Park Agreement will have a major impact on work practices. He advised that in order for Departments to get sanction for ICT expenditure, it must be linked to their Business Plans.

- Mr. Connolly advised that an Implementation Group has been set up to ensure implementation of the Croke Park recommendations. Action Plans are being received from Departments and D/Finance will ensure that these are robust.

- In response to a question from the Chairman on how the Partnership Process functions, Mr. Connolly advised that the Department of the Taoiseach is the main broker while D/Finance leads the Public Service team in negotiations. On broader issues, relevant staff from D/Finance and line Departments attend meetings. An Assistant Secretary level Group in D/Finance, which comprises membership from SPD and BTED and is chaired by PSMD feeds into the process. Partnership/pay talks do not feature in the BSM, but are dealt with via separate Memos to Government.

- Mr. Connolly noted that looking at international pay comparisons is often not useful as there is a wide variety of variables such as tax and social welfare systems which are not taken into consideration in such measures. However, the Review Body on Higher Remuneration, which considered senior pay levels did look at international comparisons and found that pay at Assistant Secretary level was in line with these and with private sector levels.

Session II: Meeting with Donal McNally, Second Secretary, Sectoral Policy Division

Political Context

- Mr. McNally gave a brief outline of the political context to the past number of years. He noted that when the new Government came to power in 1997, the public finances were in good shape. Minister McCreevy introduced a 4% rule for expenditure. The NPRF was established in 2000/2001.
- During the period of very strong growth and increasing tax revenues, the Department felt that bigger surpluses should have been run – Cyclically Adjusted Budget Balance (CABB) figures showed that Ireland should have – however this may not have been politically feasible.
- Mr McArdle noted that the EU stated in 2001 that Ireland should run additional surpluses of ½% but that commentators did not agree with this.

BSM Preparation Process

- Mr. McNally provided an overview of the BSM preparation process, explaining that work on the Memo begins in May when parameters are decided upon. Drafts are prepared in consultation with the Minister.
- A letter is sent to Departments regarding the Estimates. In Mr. McNally's experience as former Second Secretary General on the Tax side, the Minister met with Mr. McNally and a range of officials regarding tax measures.
- Concern would have been expressed by officials to the Minister about structural issues, overheating and competitiveness. However, there was increasing public expectation for greater spending. The Partnership process and Programmes for Government were also sources of pressure.
- It was noted that the fact that a significant proportion of tax receipts are received in November can impact on decision making at a late stage in the process. Mr. Wright noted that it appeared that decision making was based on fiscal policy in June/July when BSM went to Government, but that in advance of the Budget policy was based on arithmetic.
- When asked, Mr. McNally confirmed that the BSM process did become somewhat of a ritual over the years.

Property reliefs

- With regard to getting rid of property reliefs, Mr. McNally advised that the main focus was on disincentivising the buying of second properties. The aim was to phase out reliefs over a 3 year period to try to encourage a soft landing.
- In response to a question about "commentator fatigue", Mr. McNally noted that there was a level of repetitiveness in views of bodies such as the OECD which recommended the abolition of Mortgage Interest Relief for a number of years irrespective of economic situation.

Role of Department of the Taoiseach in the Budget process

- In response to a question on the role of the Taoiseach on the Budgetary Process, Mr. McNally noted that prior to 1994 all expenditure related Memorandums to Government had to be signed off by the Department of Finance prior to submission to Cabinet. He also advised that Departments had numerous opportunities to try to increase their budgets, via the Abridged Estimates (AEV), the Budget, the Revised Estimates (REV) and expenditure Memos.

- He advised that the involvement of the Department of the Taoiseach depends to a large extent on the Minister and the Taoiseach. Social Partnership also gave the D/Taoiseach an increased role in the budgetary process.

Expenditure Challenges

Mr. McNally identified the following challenges:

- Effective spending control
- Achieving Value for Money (VFM)
- Good quality Cost Benefit Analysis (CBA)
- Rational spending decisions
- Process: Department of Finance control. Publication of BSM and other advice provided.
- Structures: availability of good financial analysis and capital appraisal

Session III: Meeting with Ann Nolan, Second Secretary and William Beausang, Assistant Secretary, Financial Services Division

The main points made were as follows:

- FSD has been going through a period of ongoing change over the past two years. It is important to establish building blocks for the future now, in particular structures to improve monitoring of the financial system.

- The relationship between the Department and the NTMA must be formalised: the 2007 Memo of Understanding was to intended to facilitate information exchange without interfering in the work of the Financial Regulator. An appropriate system of interaction must be put in place between the relevant agencies that will ensure ongoing contacts when there is no crisis.

- There is a disconnection between fiscal policy (in remit of Department) and monetary policy (seen as being in the remit of the Central Bank).

- With regard to the growth in credit and property prices, it was noted that no-one, including economists, saw these issues as the problems that they were to become. It was noted that the Financial Regulator, in a meeting held with the Department and the Department of the Environment, did not express concern at the lending polices of the financial institutions. The Department may have been too "hands off" with its approach to matter.

- With regard to collaboration with the NTMA, the delegation order states that the NTMA must work in consultation with the Department – this may need to be put on a formal footing, e.g. through a Memo of Understanding. Political accountability remains with the Department of Finance; the Minster will generally contact the NTMA via Department officials. However, the Minister can seek advice from the NTMA and the Department. Work could be outsourced to the NTMA in the long term, but checks and reporting arrangements need to be put in place in advance of this.

- With regard to FSD staffing, it was stated that staffing levels could not be decereased in the short term and certainly could not return to the levels they were at pre-2008. An overview of staff numbers and work in which FSD is engaged was provided. It was noted that, while there may be an overlap in functions between FSD and the agencies, there is no overlap in work. It was noted that specialists have been taken on in the Division. The view was expressed that experts should be employed in the Department on short term – 3 year – contracts only and then replaced in order that the Department has a constant linkage with private sector developments and market related skills are maintained.

- NB Ms Nolan undertook to provide a draft outline of a framework for ongoing communication with the Financial Regulator for submission to the Panel.

- A list of outside expertise engaged by the Department and the processes by which they were engaged in will be provided to the Panel.

Tuesday, 12th October

Session I: Roundtable discussion with Assistance Secretaries

Attended by: Michael Errity, Brendan Duffy, Patricia Coleman, Robert Watt, David Moloney, William Beausang, Carmel Keane, Derek Moran (for part)

The main points were as follows:

Process dominates rather than following a strategic agenda. A lot of time is spent fire-fighting.

- **ASG:** There was some debate about the role of the Assistant Secretary Group (ASG), which was abolished earlier this year. The view was expressed that the ending of the ASG means that the Assistant Secretaries as a group are not as effective in scanning issues for MAC. Others noted that the ASG had become debased over time and that its functions became trivialised, dealing in the main with staffing and corporate service type issues.

- **MAC:** With regard to the MAC, it was also noted that, prior to the disbandment of the ASG, the Group had sent a note to MAC recommending regular meetings of the full MAC. In some other Departments (D/Health was mentioned) papers are circulated for discussion at MAC – this does not happen in D/Finance. There is no formal debrief of A/Secs not on the rota to attend MAC.

- **Budget process:** It was noted by some that the process in place for producing the annual Budget is good – the Budget Coordination Group of A/Secs have discussions on policy and measures, which then go to MAC. Other A/Secs, not as closely aligned with the process are not necessarily aware of the issues being considered unless they relate directly to their area. With regard to the matter of the rituality of the Budget process, it was remarked that the issue was one of leadership – how hard were Department views pushed? It was commented by others that the Department was not listened to and became sidelined.

- **Skills in Department:** Views were expressed that there is a shortage of macro-economic, accountancy, econometric and analytical skills in the Department and that there is little focus on developing the skills that the Department has. It was proposed that: the Department should continue to recruit people with appropriate skills and at different levels; there should be a competition for each vacancy rather than the setting up of panels; the number of promotions that go to external people should be increased and staff should be encouraged to gain experience in other bodies such as the Central Bank and NTMA. It was noted by others that since 2000, when skills needs of the Department were examined, the focus has been on hiring economists and that management has a role in the development of their staff. There are a number seconded to external bodies such as the EU Commission, who will return to the Department, which is valuable to the Department. There was some discussion on the use of specialists in the Department, with questions being raised as to how economists would be integrated across the Department. In response to a question from the Panel, it was noted that, while the Department is capable of supporting the Minister is leading the economic recovery process, it is not fully "tooled up". A team based structure is required as is support from other Departments such as D/Enterprise, Trade and Innovation.

- **Staff management:** It was noted that underperformance is an issue. It was also noted that, while achievement of tasks is important in the Department of Finance (and others), the same value is not attached to how these tasks are completed. A change in culture in needed to deal with underperformance. It was confirmed that the probation period is used effectively. It was also stated in the context of staff issues that the poor communication is an issue – the comment was made that staff should not hear about D/Finance related matters via the media. Someone should be responsible for manpower planning in the Department, monitoring the performance and under-performance of staff and dealing with succession planning.

- **Structure of Department:** Some noted that there is a culture in the Department of "delegating" work upwards. This is partly due to the structure of the Department, which has a lot of staff at AP level and relatively few support staff. The management structure is too top heavy, with an extra decision-making layer. There was some discussion about the Divisional structure, most particularly SPD and PSMD, which have significant areas of common interest (pay and pensions – pay policy within remit of PSMD). Various opinions were expressed on how to deal with the disconnection between these areas. More broadly, it was suggested that there should be a fundamental reassessment of the alignment of Department functions. It was also suggested that service provision areas could be brought together and that there is scope for greater use of technology in certain areas.

Session II: Meeting with Deputy Joan Burton, T.D.

(Ms Burton was accompanied by her Parliamentary Assistant and the Legal Advisor to the Labour Party)

The following were the key points

- Impressions from 1992-1997 were that Department of Finance had strong role at centre of Government. That pivotal role appears to have shifted since then towards the Department of the Taoiseach. This raises the question of who is in charge. What is the key role of the Department? Partnership structures may have contributed to this.

- Information side of managing the Budget: it is now clear that nominal budget figures marked an underlying deterioration in the fiscal situation. Data and economic modelling is poor as is shown by failure to capture the impact of the property bubble on tax revenue. Macro-economic forecasting needs to be strengthened and made contestable.

- Scope for Parliamentary involvement in the budgetary debate is severely limited – there is no coherent fiscal framework (reference to the Deputy's speech at the Humbert Summer School). Changes to the Budgetary process over recent years have not been helpful, really "false reform". Output Statements are confusing and lack relevance. There is scope for significant real reform in this area.

- On the issue of a Fiscal Council would agree that its role should be independent, competent and validating.

- Deputy Burton noted the following as examples of key issues which had significant implications and where the Department should have had and did not have a significant role.
  - Decentralisation
  - Introduction of medical cards for over 70s – costs where grossly underestimated
  - Property related tax exemptions not properly costed and tax expenditures generally are not transparent and costed after the event.

- On Banking, Deputy Burton said that in her experience briefing was poor. She believed that the Department was relying on outside expertise which it was not in a position to assess adequately. In her opinion, there was a serious lack of understanding of the business/banking environment.

- Noted by the Legal Advisor that the Department has functions in promotion and coordination of economic and social planning (including sectoral and regional planning) and there was little sign of a proactive approach in this respect.

- Overall, Deputy Burton noted that there appears to be a lack of appropriate skills in accountancy, economic analysis and analytical skills generally.

However, she acknowledged the integrity and commitment of staff in the Department.

Session III: Meeting with Deputy Michael Noonan, T.D.

The following were the key points

- In most years over the past decade fiscal policies were pro-cyclical and added to the overheating of the economy.

- The impact of the property bubble was not identified. Advice of Opposition and others was ignored. In his view the Department was "tied into their Minister". Deputy Noonan referred to correspondence in 2002 addressed to the Secretary General. He noted that the reply issued from the Minister. There is no evidence that the views expressed by Opposition Deputies are heeded or taken into account. Deputy Noonan referred to his intervention on the Committee Stage of the Finance (No2) Bill, 2007 on June 2007 on the impact on tax revenue of the drop in house prices (copy attached). He noted that no effective action was taken for a further eighteen months. X Replie

- As a former Chairman of the Public Accounts Committee he said that in his opinion the reply to the Committee's Reports in the Minute of the Minister for Finance was weak and effective action was not taken.

- On a positive note, he said that in some areas service was generally better.

- Current arrangements for costing proposals from political parties are not satisfactory and lack coherence.

- The Department has no Economic Model and relies on the ESRI model which requires significant updating.

Session IV: Meeting with Brigid McManus, Secretary General, Department of Finance

Ms. McManus provided views based on experience as Assistant Secretary in the Department of Finance and as Secretary General of the Department of Education and Science.

The main points were as follows:

- Formal submissions were provided to the Minister of the day on all tax measures for the Budget and the Finance Bill. These included options, not necessarily recommendations; however the leanings of the Department would be been apparent in these submissions.
- Any overall views of the economy and on overheating would have been submitted by the economic side. With regard to housing, briefing would have been prepared on housing and the impact of a decrease in output on employment and tax receipts. There was also interaction, and briefing, from the Department of the Environment among others, on housing issues. The view of the Department, as Ms McManus recalled, was that housing was a supply-side issue. The Department was against mortgage interest relief in general, but not as strongly against such a relief for first time buyers. There was some external criticism of the abolition of reliefs as rents were high at the time. It was difficult to get data on property tax reliefs as such data was not collected by Revenue. There was considerable discussion at Cabinet regarding the second Bacon Report.
- With regard to the Department's dealings with the Department of Education, Ms McManus noted that:
    - Different messages/advice can be provided depending on the area. The Department should hammer out its view/position before engaging with Departments.
    - In the current crisis finding a strategic way of engaging Departments and a greater understanding of sectoral issues would be very useful. It shouldn't be an issue if line Departments and the D/Finance have different views on how to achieve the same end – this is counterproductive and demoralising for staff in line Departments. The D/Finance should be focussing on strategically thinking about what can be achieved rather than fighting with line Departments on every issue. A huge amount of time is spent trying to resolve relatively trivial issues – this is not conducive to a collegiate atmosphere.
    - There is a need for one source of IR expertise and understanding.

Session V: Meeting with Dr. Don Thornhill, Chairman NCC

The main points noted were as follows:

- The culture of the Department of Finance is that only the Department can understand all issues. There is a sense of defensiveness in the Department and a lack of confidence at times, reflected in the fact that the Department is reluctant to engage in debate at times. There is a reluctance to sit at the planning table with other Departments and to take hard lines in initial discussions with Departments.

- It is not fair to criticise the Department regarding the quality of economic forecasting in recent times as no-one knew the extent of what would happen.

- There was reluctance at political level to hear anything unpalatable as well as a huge commitment to partnership. What was missing was the administrative structure required to enable officials to deliver unpopular advice.

- With regard to competitiveness, the Government had a distribution policy, i.e. share the wealth. The NCC pointed out the transient nature of stamp duty and argued for a property tax; however, there was no traction politically.

- A number of officials from Government Departments attend NCC meetings including D/Finance. Attendance at meting varies. The NCC meets the Minister for Finance once a year.

- There appears to be a deficit in technical expertise (economic/econometric) in the Department.

- Dr. Thornhill strongly supported the concept of the Fiscal Council.

- Systemic issues and challenges: Out of date recruitment – there is a need for open recruitment at all levels.

- TLAC: there is a strong cultural bias in the form of XXXX civil servants. The process is not "fit for purpose".

- The culture of the generalist rather that the specialist is pervasive. This must be addressed to meet the needs of a modern Finance Ministry.

Wednesday, 13th October

Session I: Meeting with Colm Kelly, Senior Legal and Tax Partner, PWC

The main points made were as follows:

- Mr. Kelly outlined his contacts with the Department. Interaction generally relates to tax policy issues, mainly with regard to the international business environment. His view was that the Department has a good perspective in this regard and that dialogue with Department officials has been constructive. The Department did not lose sight of sustainability in the business tax framework. In his view there is a disconnect between the public perception of the Department of Finance and his experience in dealing with the Department – his view is that officials are professional, capable, committed and have a strong public sector ethos. This perception gap needs to be closed but Mr. Kelly was unsure as to how this could be done.

- In 2005-2006 there would have been general awareness in the industry of an imbalance in the tax system and concerns about the lack of competitiveness. Would have known that growth could not continue at previous rates, but no-one could have foreseen the extent of what was coming.

- With regard to competitiveness, the way in which the global economy moved meant that being a small peripheral island didn't matter. Ireland did a huge amount of catching up in the mid-late 1990's. Ireland's competitive advantage in the earlier period was based on cost and tax. Development in manufacturing to high end production masked the loss of competitiveness. He pointed out that you have to know what you are going to target in order to put an appropriate competitiveness framework in place.

- Growth rates were used as the benchmark for success. This overlooked what economic policy was attempting to achieve. There is a natural inclination to focus on statistics rather than policy objectives. Perhaps the wrong things were being measured.

- Social partnership was a political convenience – there was no overall view of what we were hoping to achieve. However, partnership may be needed now more than ever to formulate a collective view of where we want to be in the next 5-10 years.

- The budget timeframe is very short. There is a lack of debate and a poor understanding of where we want to go. At the moment there is a huge amount of negative public comment, with each commentator speaking from their own perspective. After a pick-up in confidence after the last Budget, the country is now paralysed again due to bond market developments. Good dialogue and planning would ease this. EU developments also have the potential to be helpful.

Session II: Meeting with David O'Callaghan, Chairman, Department Capacity Review

The main points were as follows:

- Mr. O'Callaghan gave an overview of the data gathering exercise used for the Capacity Review.

- He noted that an amended version of the Report was published. A considerable amount of cooperation and high quality, high level opinion and facts fed into the Report, but this was possibly not fully reflected in the published Report.

- The Review found the Department to be an organisation of many parts, with a large number of silos. External people gave positive views of the "treasury" element of D/Finance. However, it was the view of Secretaries General of other Departments that measures that might be sanctioned by one side of the Department (e.g. SPD) could require a round of further talks with another side of the Department (e.g. PSMD).

- Views of the Department included the following:
    - Department good at "full back" role, but no flair in evidence;
    - Not good at strategy;
    - Cautious, no sense of creativity or new ideas;
    - Sense of disengagement with regard to big issues, e.g. ageing population;
    - Expenditure Reviews of no benefit;
    - More productivity needed;
    - Department needs to take the lead on TPS agenda;
    - Department has no understanding of sectoral issues. Should be part of implementation teams;
    - Senior public servants don't have the same respect that they used to;
    - Department had lost control of what was happening with the EU and Ecofin – capacity issue;
    - Too much compartmentalisation in the Department;
    - Department should be more open.

- The Capacity Review recommended that the number of Secretaries General should be cut from 5 to 2 and that 2 or 3 Assistant Secretary posts should be cut. MAC was seen as somewhat dysfunctional.

- There was confidence in the Department that they could handle whatever came along.

- There was a view that the Public Sector and "Finance" sides of the Department could cooperate better but no suggestion that they should be amalgamated.

- With regard to skills sets in the Department, Mr. O'Callaghan noted that many have degrees in economics, but there are fewer financial management and accountancy qualifications. Performance management was not being tackled by the Department and some people were not assigned to the right area. The quality of staff could not be differentiated by grade but generally at Assistant Secretary level people were highly motivated and capable. He could not see signs of slippage in staff quality in the past 10 years.

Session III: Meeting with Frank Daly, Chairman of NAMA

The main points raised were as follows:

- Mr. Daly pointed out that he had a number of phases of engagement with the Department; as Revenue Commissioner and Chairman, as Chairman of the Commission for Taxation, as Public Interest Member on the Board of Anglo and in this current position as Chairman of NAMA.

- Main engagement with the Department was when in Revenue. Engagement with the Department centred around the Budget process and Finance Bill. The Budget process was very formulaic and consisted primarily of an exchange of letters between the Department and Revenue – meetings would have been a more useful format.

- He was of the view that Revenue forecasts were more positive in outlook during the boom years due to the proximity of the organisation to areas of activity – he felt that this was an underused Revenue resource.

- Contacts during the preparation of the Finance Bill were structured and very good.

- With regard to the change in the tax base over the past number of years, Mr. Daly commented that a structured look at the tax base every 8-10 years may have created more awareness of the erosion of the base. There was public expectation during the boom years that things would remain good and that taxes could be cut. Some measures to strengthen the tax based were suggested by the Commission on Taxation, but the group was constrained by the fact that measures had to be revenue neutral and the fact that the Commission was very large – 19 people, including social partners – which meant that consensus was difficult to attain.

- In the earlier years very few tax reliefs were costed – for many reliefs no data was collected as Revenue wanted to keep the system simple. Data is now being collated on tax expenditures.

- Suggested that tax dates could be changed so that there is not so much reliance on October and November receipts. This would facilitate earlier publication of the Budget. However, there would be resistance from professionals on this.

- Suggestions for the Department looking forward:
  - Department should engage more widely. There should be greater mobility of staff.
  - An expert group should be established to examine on a periodic basis the structure of the tax system (i.e. Commission on Taxation model).
  - FSD has very talented and motivated people, but they are possibly struggling to deal with the realities – something needs to be done here.
  - Because of the crisis, there has not been an opportunity to step back to determine the roles of the Department and the NTMA. Concern was expressed at the Department's role being lessened, given the experience of the last few years.

- If a Fiscal Council is established, it should not be fully populated by academic economists. The Council should be expert, independent and validating.

- With regard to the Department's response to the crisis, there was quite late engagement. The Department relied on the Financial Regulator and the Central Bank and was let down by them. Given the tools at the Department's disposal, they responded fairly well. They didn't have the information to determine that there was a liquidity and a solvency problem; whether the banks knew this is moot.

Session IV: Meeting with Eddie Molloy, Advance Organisation and contributor to Irish Times

The main points raised were as follows;

- C&AG Reports – the C&AG seems powerless to follow up on his Reports and his work is done after the event. The PAC is very politicised. There is a lack of accountability.

- Following the Mullarkey Report 2003, a provision now exists whereby and official can put his views in writing if s/he disagrees with a Minister on an issue and this can be copied to the C&AG. How often has this provision been used? The provision relates to impropriety in the use of funds.

- One of the functions of the Department of Finance should be to ensure financial strength (financial ability and accountancy) through the ranks and across Departments and public bodies. There seem to be gaps in this. What structures exist for support areas such as IT, HR and Finance?

- There is a different view of expenditure and waste in the public and private sectors. The attitude to public money has to a large degree come from the political system. Culture is important, as well as rules – what is the attitude to rules? In order to change the culture there must be sanctions. Transparency is also important.

- Social Partnership – many bodies were not included in the process, e.g. small business and employees who were not members of unions. The State has serious failings as regards our social system and the partnership process doe not address these.

- Showed the Panel template of balance scorecard. The scorecard facilitates the measurement of different elements such as GDP/GNP/Debt, wealth creation, infrastructure and social justice and quality of life.

- Performance Management: Stated that public service management is an enormous function and claimed that just 5 people in the Department are qualified to deal with this in the Department. PMDS doesn't work. Bonuses are a part of salary. The ability of line managers to manage people is questionable – do managers identify with their managerial role? Claimed that 81 of 82 advertised posts were filled internally. The management of key external relationships by the Department is important.

Session VI: Strategy for Economic Recovery - Multi Annual Framework
Robert Watt and Barry O'Brien

The main points were as follows:

- Overview of intentions of the 4 year plan: The plan is needed, most particularly to stabilise the markets. The aim of the plan is to reach a deficit level of 3% of GDP by 2014. In 2011 the deficit will be 11%+ of GDP. Significant adjustments must be made to reach our targets – these are likely to be front-loaded. The extent to which the details of the measures to be taken over the next 4 years will be made public is yet to be decided. Departments are being consulted on expenditure. Broadening of the tax base is being looked at, as well as measures to improve competitiveness. The aim is to have a fair, credible plan that will give hope.

- It was noted that the Department has had very strong control over expenditure in the past 2 years but that during the boom times this was difficult to maintain. The Department is reforming the way the Budget is produced, e.g. via the establishment of a Fiscal Council, Performance Budgeting etc.

Thursday, 14th October

Session I: Meeting with David Doyle, Former Secretary General

The main points were as follows:

- Advice was consistently provided on the overheating economy. It was clear during the period 2001-2006, when Mr. Doyle was Second Secretary General SPD, that fiscal policy decisions were considerably ahead of anything recommended by the Department. People voted on the basis of Programmes for Government which were promising higher spending and lower tax. There was also pressure from the Social Partners. Messages on economic policy must be delivered to the Cabinet by the Taoiseach or the Minister for Finance. Mr. Doyle himself attended just 2 Cabinet meetings throughout his career.

- The bursting of the dot-com in 2001 gave rise to a reassessment. Advice was provided by the SG (Mr. Doyle) to the Minister and the Taoiseach at this time and there was short term acceptance at political level of the fiscal and economic situation. Serious, robust conversations were held with the Minister in 2007 on emerging issues.

- The pace of economic activity was strong in 2001-2006 but the Department did not believe that this could continue. In 2005/6 the Minister was advised that the country was depending on unsustainable tax revenues that the economy had been dramatically over-heated and that problems would emerge which would be due to domestic policies and that a more sustainable fiscal position had to be maintained. A presentation to this effect was made to Secretaries General.

- There was a significant amount of activity between the Department and line Departments between submission of the BSM to Government and the finalisation of the Budget, as the Estimates Files will show. The Department did not agree with massive spending increases and made this clear to the Minister. Political events had an impact on policy.

- In 2000-2006 debt levels were in low double digits – related to specific approach of the Department.

- By 2007 the damage was done. While fiscal policy was one dimension, credit policy, which was highly inappropriate, had an even greater impact. Credit policy was in the remit of the Central Bank, which had the function of ensuring that financial market conditions were appropriate for sustainability. The Department fought to retain financial regulation within the remit of the Central Bank. The outcome was that the regulatory body was set up in the ambit of the Central Bank. The ECB's supervisory role with regard to the Central Bank was questioned.

- With regard to communication, Mr. Doyle noted that the introduction of the Pre-Budget Outlook was an attempt to may budgetary information more user friendly. However, negative changes in the economy outpaced these changes. Parliament needs to engage more with the Budget. The Department could have a more formal and thorough engagement in the Programmes for Government and Social

Partnership Agreements before they are adopted.

- With regard to the suggested pro-cyclicality of Budget 2008, it was asserted that there may have been a lack of engagement by the Government with the economic situation for a number of months which was due to political circumstances and priority issues for the Government such as the Lisbon Treaty Referendum and ongoing Social Partnership talks. The Taoiseach and Minister were advised of the need for a rational fiscal policy. Some external commentators were seeking fiscal stimulus and there was also political pressure in this direction. The cumulative impact of media and political comment during this period was to cause concern to consumers and investors.

- With regard to restructuring the Department, Mr. Doyle advised that a number of reviews of the Department had been carried out over the years. One of the key messages from these is that the development of people is crucial. There is a need for the accelerated development of the HR function. The Department needs more skilled and qualified people in diverse fields. Graduate recruitment needs to accelerate and these recruits should be involved in exchange programmes with organisations such as the Treasury, the Fed and other relevant bodies to glean experience and skills. This should be driven by the Department.

- With regard to the Public Service function of the Department, while this could possibly have been integrated more fully with the rest of the Department, decisions with regard to resource allocation are integrated. This is not so in the case of resource decisions for individual Departments, however, who may articulate the view that resource "battles" must be fought twice with D/Finance. However, Mr. Doyle does not advocate full integration of vote and administrative budget sections at the moment. Specialists are required for the HR management function to deal with pay and conditions, annual leave, EU directives etc. These areas cannot be separated from the pay bill. SPD and PSMD could be put under one Head of Division – areas could be integrated but not complete assimilation.

- Suggested that TPS could be dealt with by a stand alone office – Change Management Office – with a clear and separate identity.

- With regard to the management structure, it was noted that top management is imbalanced. Would not see reason for decreasing the number of Assistant Secretaries, given the range of activities in which the Department is involved. The Department does not manage sufficiently. There is not enough staff development or policy analysis and there is inadequate downward delegation. Reallocation of resources is needed.

Session II: Meeting with Cathy Herbert, Advisor to the Minister

The main points noted were as follows:

- With regard to staff, there are some very good AOs in the Department. Some staff at higher levels may push work upwards. A lot of hard work falls on a few shoulders.

- The structure of the Department is hierarchical. The Minister generally speaks to officials at Assistant Secretary level and upwards. The Minister does not see the experts brought into the Department very often. The Department may need to learn how to deal with experts taken in. Also, when the Department takes in experts, they should only be retained for a limited time.

- The ability of Department officials to write clear, simple briefing notes is not good. No priority is attached to this skill and its importance is underestimated. There is a need to effectively communicate the difficult decisions being taken. The Department has a tendency to see itself as outside of the political process (as opposed to party political). There has to be more awareness of the need for public buy-in for Government policies. The Department should try to inform the media agenda to a greater degree.

Session III: Meeting with Mr Dermot McCarthy, Secretary General Department of the Taoiseach

The key points were as follows:

- Government were advised of financial and economic vulnerabilities and a sense of concern was registered. However, the unprecedented global financial collapse was not envisaged.

- It was recognised that there were domestic vulnerabilities e.g. loss of competitiveness, overvalued property prices, increasing public expenditure which interacted with the global crisis.

- Important to understand that the Budget Strategy Memorandum is an articulation of the framework mid-year and is the beginning of the budgetary process. There are many interventions in advance of the budget and the Minister for Finance has a central role on an ongoing basis.

- Sustainability was a key issue and the risks were articulated and understood. The expectation was given the Irish economy's strong economic fundamentals, that those risks were manageable. The central scenario was, therefore, for a soft rather than a hard landing.

- Budget surpluses were recorded during this period and there was significant investment to provide key infrastructure such as roads, public transport, schools etc.

- What more could have been done? There were numerous positive views for the Irish economy from OECD, EU and ESRI. Growth in expenditure was clearly an issue. A medium-term budgetary framework would have been helpful. Recent developments at EU level will provide for the outlining of budgetary strategy at an earlier stage of the year – in April 2011 in respect of 2012. There will also be wider surveillance of all macroeconomic developments.

- Strengthening the Department going forward: Additional skills in economic analysis, accountancy and banking are necessary in what is essentially a knowledge organisation.

- **Public Service Reform**: Department has three distinct roles:
    - Cost Control/Numbers/IR
    - Goal setting, Accountability and animation of the Transformation agenda
    - Leadership of the Transformation Agenda.

- The distinct roles of the Department of Finance and the Department of the Taoiseach must be clearly understood.

- The Department of the Taoiseach role is to evaluate and account for performance which is essentially oversight. The levers for delivery of the change agenda are in the Department of Finance. This is a challenging role and requires different skill sets to those usually found in a Finance Department. There is a clear need to strengthen capacity and to restructure the management of the change agenda.

- Response to Crisis: The Department's response has been impressive and the design of the response has been good. However, it has identified shortcomings in the knowledge base, weaknesses in structure and the need for expert resources in a number of areas. The Department has been slow in increasing capacity to meet the requirements of a Finance Ministry now and for the future.

Session III: Meeting with Departmental Partnership Committee Meeting

(List of attendees to be supplied by Dermot Clynes)

The Panel members attended the start of the DPC meeting.

The main points were as follows:

- The Chairman outlined the Terms of Reference of the Review. Each Panel member gave an overview of their respective experiences with regard to the role of Finance Departments. They informed the meeting that the aim of the Review is to leave behind a template to improve and strengthen the Department, not to apportion blame.

- In response to questions from the DPC representatives, the Panel and Secretariat confirmed that:
    - The impact of Social Partnership and Programmes for Government on the fiscal situation is being looked at;
    - Ways to address people management and performance are being considered;
    - There will be further opportunity for staff to make their views known to the Panel via a consultation process following the model of that used for the Capacity Review;
    - Ways of making MAC more effective will be suggested.

- Other points noted by staff:
    - PMDS needs to be revamped.
    - There needs to be better matching of skill sets to jobs.

Session IV: Meeting with Michael Tutty, Energy Regulator and former Second Secretary General, BTED

The main points were as follows:

- Department forecasts were conservative – there was a realisation that growth could not be sustained at current levels. There was a small economic team in the Department, and it drew on the expertise of the Central Bank and the ESRI. The advice was always to run bigger surpluses.

- The Department was generally not in favour of tax reliefs – lowering tax rates was preferable. Costing of reliefs was difficult as the numbers that would avail of each relief was unknown. It was noted that property reliefs started out with the beneficial aim of regenerating urban areas, but they spread beyond their original purpose.

- There was not always written communication to the Minister regarding contentious issues; the Secretary General would have spoken to the Minister on such matters. Most disagreement was verbal. Significant issues were put in writing.

- Social partnership was initially a useful process, but became a means of distributing largesse as time went on.

Friday, 15th October

Session I: Meeting with Eoin Dorgan

The main points raised were:

- There is no Department Communications Strategy as such. Rather there is a piecemeal approach to communications, depending on the event.

- There is a question as to whether the Press Office is the Department or Minister Press Officer – can be a balancing act.

- There is an open door policy for the Press Officer – can speak to whichever official is best placed to deal with the issue at hand. The Press Officer also has full access to the Minister.

- The Department is not good at communicating decisions taken, particularly with regard to banking policy and was behind the curve initially. The Department pays great heed to confidentiality and commercial sensitivities.

- A number of press briefings have been held on banking matters. Journalists are spoken to on an ongoing basis to ensure that they have background context to decision making. Mr. Dorgan noted that the general feedback from journalists is that the Department of Finance is one of the better Departments for communicating and making information available vis-à-vis other Departments.

- The Panel raised some concerns regarding the communication in the Department:
  - The Department is reactive rather than proactive;
  - There are no guidelines in place for staff as to how to deal with the media;
  - Question of coordination of Press Statements when different elements are produced by different sections in the Department;

- In response to a question from the Panel, Mr. Dorgan stated that if would be useful to let officials go on radio etc. to deal with some issues, but advised that there could be conflict with the Minister if views expressed were interpreted in a particular way.

- Mr. Dorgan undertook to speak to other Departments, to colleagues in Departments of Finance abroad regarding their communications strategies and to speak to the Panel again during their next meetings.

8 November, 2011

MISJUDGING RISK: CAUSES OF THE SYSTEMIC BANKING CRISIS IN IRELAND

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

MARCH 2011

Executive Summary

Introduction

Systemic financial crises, like the recent Irish one, require a great number of institutions, enterprises and individuals to simultaneously follow unsound policies or practices. Each one is, of course, responsible for their own actions and inactions contributing to the accumulation and realisation of risks in financial markets. Nevertheless, responsibility for such a crisis is likely to be widely distributed. The Commission has, in keeping with its Terms of Reference, evaluated how various institutions contributed to the Irish financial crisis.

This Report explores what the Commission considers to be the most important policies, practices and linkages that contributed to the financial crisis in Ireland. A very large amount of documentation was analysed and many relevant people were interviewed. In explaining the simultaneity of the failures in Irish institutions, the Commission frequently found behaviour exhibiting bandwagon effects both between institutions ("herding") and within them ("groupthink"), reinforced by a widespread international belief in the efficiency of financial markets. Based on this, the Report finally offers some lessons that could help avoid future similar occurrences in Ireland and elsewhere.

Much points to the development of a national speculative mania in Ireland during the Period, centred on the property market. As in most manias, those caught up in it could believe and have trust in extraordinary things, such as unlimited real wealth from selling property to each other on credit. Even obvious warning signs went unheeded in the belief that the world had changed and that a stable economy was somehow automatically guaranteed. Traditional values, analysis and rules could be gradually less observed by the banks[1] and authorities[2] because their relevance was seen as lost in the new and different world. When it all ended, suddenly and inexplicably, participants had difficulty accepting their appropriate share of the blame for something in which so may others were also involved and that seemed so reasonable at the time.

Preconditions for the Crisis

The international developments that facilitated the excesses in Ireland have been exhaustively documented in previous scoping reports. Entry into the euro area markedly reduced Irish interest rates. Banks had increased access to market funding, where cheap and abundant credit was already available owing to monetary policies in major countries as well as the increasing use of securitisation.[3] Globalisation of markets and EU membership increased foreign competition in the Irish financial

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[1] Throughout this report the term 'bank' will generally be used to refer to both banks and building societies and should be construed as such.

[2] Throughout this report the term 'authorities' will be used to refer to the Irish Financial Services Regulatory Authority (the Financial Regulator), the Central Bank of Ireland and the Department of Finance or to any one or combination of these.

[3] The practice whereby banks sold off their loans to investors (often non-bank financial firms) by creating a security with these loans as collateral. The proceeds could then be used for providing additional loans that, in turn, could be securitised. Since banks but not the investors needed minimum capital, the same capital base could be used for substantially greater lending than before.

market, putting pressures on bank margins. A number of new, potentially high-risk retail products were introduced to the Irish market by new entrants (for example, tracker mortgages, 100% mortgages for first-time buyers). Last but not least, the paradigm of efficient financial markets provided the intellectual basis for the assumption that financial markets, left essentially to themselves, would tend to be both stable and efficient.

International developments, however, did not in themselves cause the crisis though they helped precipitate it. The problems causing the crisis as well as the scale of it were the result of domestic Irish decisions and actions, some of which were made more profitable or possible by international developments. Though eventually unsustainable financial risks were made attractive by outside factors, there simply was nobody abroad forcing Irish authorities, banks or investors to accept such risks. The way Irish households, investors, banks and public authorities voluntarily reacted to foreign and domestic developments was probably not very different to that in other countries now experiencing financial problems. However, the extent to which large parts of Irish society were willing to let the good times roll on until the very last minute (a feature of the financial mania) may have been exceptional.

Contagion

The willingness of banks to accept higher risks by providing more and shockingly larger loans primarily for commercial property deals was an important reason for the gradual increase in financial fragility in Ireland. This willingness occurred because of the emergence of strong foreign and domestic competitors within both the residential and commercial property lending markets. By mid-decade, Anglo Irish Bank (Anglo) and Irish Nationwide Building Society (INBS) were growing strongly on the basis of relationship banking, providing loans to a limited number of entrepreneurs operating in the riskier parts of the property market. Anglo in particular was widely admired domestically and abroad, and lauded (by many investors, consultants, analysts, rating agencies and the media) as a role model for other Irish banks to emulate.

This seems to have led to a gradual adoption of lower credit standards by a number of Irish banks (and it appears to the Commission that this was also the case for foreign-owned banks, as evidenced by reported losses) as a method to sustain market share and profitability. In some covered banks this strategy was consciously adopted by the board and was properly delimited. In other banks, boards seem to have simply decided on higher target growth rates, with little apparent realisation of the attendant risks; implementation (and risk policy) was implicitly left to staff.

Bank loans seem to have expanded so rapidly because neither banks nor borrowers apparently really understood the risks they were taking. Many banks were increasingly led and managed by people with less practical experience of credit and risk management than before. Property-related lending was seen as “really the only game in town” for growth-oriented banking. The purchase of second or more properties by individuals was seen as “a no-brainer”. Rapid loan growth could not be funded by retail and corporate deposits; consequently, banks turned to the wholesale market.

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

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

Consensus

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

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

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

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

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

Flawed lending: Anglo and INBS

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

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

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

The Financial Regulator(FR) was clearly aware of many of these problems in the two banks. Prior to the commencement of the Period, and consistently throughout, it raised significant concerns regarding governance at INBS. It also submitted a comprehensive list of procedural and portfolio problems to Anglo. It furthermore raised minimum capital ratios for both banks. However, such remedies did not prove effective to ensure sufficiently greater prudence and accountability in either of the banks. The system-wide increase in capital charges on certain property loans in 2006, while appropriate in principle, proved too modest in a situation where property lending appeared hugely profitable.

As a result, to outsiders, the two banks may have appeared to operate in ways broadly acceptable to the FR. This may have increased their importance as role models for other Irish banks. It must also have given comfort to leadership in the two banks themselves and encouraged them to continue with these practices.

The Herd: Other Banks

Bank management and boards in some of the other covered banks feared that, if they did not yield to the pressure to be as profitable as Anglo, in particular, they would face loss of long-standing customers, declining bank value, potential takeover and a loss of professional respect. The few that admitted to feeling any degree of concern at the change of strategy often added that consistent opposition would probably have meant formal or informal sanctioning.

Bank management and boards generally gave in to this pressure, in the bigger banks more so than in the smaller ones. Strategies chosen included concentration on retaining market share, increasing earnings growth and protecting the banks' franchise. The implementation of these strategies as well as comprehension of what they meant for the bank's risk profile varied between institutions. At their most prudent, limits were placed on credit volume to riskier markets and customers were selected based on prudential characteristics. At the other end of the scale, boards adopted general high-growth credit volume or profit targets without apparently really understanding how they would be implemented in practice by staff. It seems to have been quite generally accepted that – traditionally volatile – market funding would continue to be available to enable the achievement of growth targets. The relative level of prudence of the banks, on both the asset and liability side of the balance sheet, was eventually reflected in the extent of the losses suffered by each institution.

Unfortunately, in many cases the documentation of discussions among board members over the Period was, in the view of the Commission, insufficient. A number of members interviewed indicated a strong preference for consensus on boards as well as among managers. It appears to have been difficult for individual members, especially those without banking experience, to express and maintain a view contrary to the majority view on the board. In some cases, members indicated that their approach was to initially register their opposition to a particular decision, but to then adopt the majority view. Contentious issues or strategies were, probably also in the interest of efficiency, seldom revisited unless it was jointly agreed to do so. Over time, managers known for strict credit and risk management were replaced; there is no indication, however, that this was as a result of any policy to actively encourage risk-taking though it may have had that effect.

In addition, there were some indications that prudential concerns voiced within the operational part of certain banks may have been discouraged. Early warning signs generated lower down in the organisation may in some cases not have reached management or the board. If so, the pressure for conformity in the banks has proven to be quite expensive.

The Silent Observers: External Auditors

The auditors, like other professionals in the banks, had the skills, opportunity and procedures required for detecting and evaluating asset and funding risks. While not working full-time in banks, by long tradition auditors have full access to bank documentation and pronounce on the accuracy of the historic accounts on the basis that the bank will remain solvent a year forward. Within their specific remit auditors provide often voluminous reports to their clients.

Auditors have a number of ways to inform bank leadership of any concerns. In addition to the public audit opinion they give the Audit Committee a more detailed report on their findings on the business and provide a letter setting out any weaknesses identified in the bank's reporting systems. They are also required to provide the FR with copies of these reports. Auditors' commentary, however, regularly focuses only on issues which they consider relate to the accuracy of the historic accounts. In practice, this means that auditors look primarily backwards and at technical issues that may influence the accuracy of the accounts. Nevertheless, auditors are also required to assess whether a bank will remain a going concern for the next year; this seems to require them to make a judgment on at least the short-term sustainability of the bank's business model and strategy.

The auditors clearly fulfilled this narrow function according to existing rules and regulations. They did not, however, generally report excesses over prudential sector lending limits to the FR. Even if they had, it appears unlikely that anything would have been done about it as in general the FR was already aware of such limit excesses.

A judgment on whether the bank is a going concern for the next year would appear to depend *inter alia* on the quality of governance in the bank. It might be reasonable to argue that a bank's governance and procedural problems may, over time, be reflected in the quality of its loan book or in the stability of its funding, particularly when inherent risks in these are growing rapidly. For banks, closure usually comes because liquidity dries up; only later may it turn out that the bank's assets also are impaired and have caused its creditworthiness to decline. It may be difficult to accurately judge exactly when this occurs. In fact, this is what happened in Ireland, where banks had to be rescued from closure by the Government Guarantee in some instances not more than six months after being given clean audit opinions.

The problems in the Irish banks were building for several years before the crisis. These were problems of credit quality, sustainable lending practices and adequacy of internal procedures; they were not generally operational problems related to the IT systems or the mechanics of loan documentation. Auditors, therefore, did not feel that commenting on the implications of such business model problems fell within their proper remit. In fact, it may be questioned whether they even saw them as problems since very few others appear to have seen them either. On these issues, they appear generally to have stayed silent.

The problem of clean audits followed by a threat of closure a short time later is not new nor is it limited to Ireland. As a result of the global financial crisis several initiatives are under way to explore ways of making audits conform to the "watchdog" expectations which are both in the market and among the public. It would be useful if the Irish authorities, building on their own experience, would take an active role in these deliberations.

The Enablers: Public Authorities

The Central Bank (CB) and the FR noted macroeconomic risks and risky bank behaviour but appear to have judged them insufficiently alarming to take major restraining policy measures. Among all the authorities a very limited number of individuals, either in boards or among staff, saw the risks as significant and actively argued for stronger measures; in all cases they failed to convince their colleagues or superiors. Thus the authorities largely continued to accept the credit concentration in the property market and avoided forcing action on the failings in the banks. The Government actively supported the market over an extended period against the apparently fairly weak but clear opposition of the Department of Finance (DoF).

The CB had a pivotal position, itself contributing to overall financial stability and being able to direct the FR. In the view of the Commission, macroeconomic developments were already exhibiting signs in 2005-2006 that reasonably should have caused concerns in the CB. However during the Period in question, it did not take forceful measures but largely confined itself to providing reminders of existing risks. This did little to alert banks or other authorities to the growing foreign debt or to potential stability risks from the property boom and the overheating economy. The need to avoid spooking the market appears to have been an increasingly common reason to do and say little; however, this cannot explain the lack of clear confidential warnings to other authorities. There may have been a state of denial in the CB; warnings of stability risks appear to have been sidestepped internally or, when made public especially in the Financial Stability Reports, toned down in the policy conclusions. Trust in a soft landing was consistent and, though not very well founded, continued up until and including the crisis management phase of the Period.

The CB was not powerless; it had the right to direct the activities of the FR and it could advise the Government. There are, however, no records of such direction or advice or even efforts at such. These institutions worked separately and their respective independence was repeatedly stressed; however, this was counteracted by their partly common board members. Until the crisis, many of the staff of the CB and the FR apparently did not cooperate in a sufficiently meaningful way in assessing financial stability. This, together with the determined optimism and caution of senior management, may help explain why so few staff were seriously concerned about stability issues at the time. It appears that each of the authorities ultimately assumed that the other conscientiously fulfilled its prudential tasks. Thus, less was done than either of them assumed.

The problems in Anglo and INBS in particular, were not hidden but were in plain sight of the FR and the CB. The funding strategy of Anglo was obvious from its balance sheet and the concentration to the more speculative part of the market was generally known. Similarly, INBS's expansion into development lending was also clearly documented and the governance problems in the bank were widely known by the authorities. While these issues were repeatedly addressed by the FR, only modest results were eventually achieved as their later losses indicate. While the poor state of loan documentation in INBS and insufficiency of collateral in both would have required closer inspection, such information was readily available to the FR. Had they considered it necessary or appropriate, there was sufficient information to have allowed the authorities to take more decisive action than was the case.

Surprisingly, since the FR saw itself as regularly meeting with the banks, interviewed bank management and board members could not recall any meaningful engagement with the FR on prudential issues (except technically, as part of the Basel II process).[4] According to bank management, prudential issues were tick-the-box checks that formal procedures were in place, not checks on how they worked in practice. On the contrary, when prudential sector concentration ratios were exceeded, the FR did nothing to demand any limitation in risk exposure despite being fully informed. The FR's passiveness with regard to sanctioning, as a matter of urgency, the weaknesses in governance and risk management in Anglo and INBS has been set out above. Consumer issues were exhaustively, publicly and actively dealt with by the FR, however.

The DoF and the Minister for Finance were regularly provided with a Financial Stability Report, officially jointly written by the CB and the FR. In practice, the FR appears to have participated primarily at board level.[5] The report occasionally made reference to the frothiness of the Irish property market but did not explicitly infer serious risks to the banks from this emerging bubble. The banking sector considered the overall tenor of the report to have been benign and comforting. Being conscious and supportive of the independence of both the CB and the FR, the DoF provided very little comment or input to this process,[6] nor did it assess how they fulfilled their duties until very late in the Period.

Neither the CB nor the DoF seem to have considered the implications of a possible interruption in the flow of foreign funding. If such a scenario had been considered, the link between such funding, property market developments and bank solvency could perhaps have been uncovered.

Generally, international organisations (IMF, EU, and OECD) were, at most, modestly critical and often complimentary regarding Irish developments and institutions. This gave the authorities and the banks additional reason to assume that all really was well. Domestic doubters were few, late and usually low-key, possibly because it was thought that expressing contrarian views risked sanction; in addition, a long period of good times had reduced the numbers of those willing to continue to go against the prevailing and apparently proven consensus.

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[4] Given that the FR did send post-inspection letters to banks requiring serious action, this view is difficult to explain. In one late case, it appears that the letter was not distributed to the Board. In other cases, it may be that FR contacts were made by "too low-level" officials or that the issues were seen as technical rather than strategic in importance. Finally, it may be that issues that the senior FR officials considered substantive in a prudential sense were seen by bankers as formal or technical only.

[5] This was explained to the Commission as the combined result of *inter alia* bad relations at times between leadership and staff in the two institutions, time constraints by regulatory staff, the lack of economics skills in the FR and difficulties in achieving mutual comprehension (the different professional languages of economists and accountants). To the Commission it seems that this lack of cooperation is stemmed largely from lack of leadership at various levels in both institutions. Cooperation problems may have been compounded by a solid lack of understanding of stability issues at most management levels.

[6] The Secretary General would provide comments as a member of the Board of the CB. His membership could, for its part, possibly also reassure DoF staff that the CB and, to the extent that stability issues were raised by the FR at the CB Board, that also the FR was doing an adequate job.

Policy with Insufficient Information: the Guarantee

The lack of suspicion and the absence of sufficient information on the underlying quality of the banks' balance sheets is likely to have had a significant impact on the alternatives that were considered reasonable on September 29, 2008. Proper information is a precondition for any crisis management based on reality. As it turned out, decisions were made on the erroneous assumption that all banks were and would remain solvent. Only on that assumption could the decision to simply provide a broad guarantee be understood.

Given the information available and the imminent liquidity problem at the time, the Commission understands the pressing need to ensure access to liquidity for the banks the next morning. The broad and legally binding guarantee did, however, represent a considerable risk to the sovereign in the case of any negative surprises. Moreover, there appears to have been some market perception that Irish banks were excessively exposed to the property market and the consequent risk of bad debts. It could, therefore, have been useful to consider using other available financing for a few days, using the time to assess ways of limiting the Guarantee and to urgently scrutinise the state of some banks. Given market sentiment at that time, however, the risk of further destabilising the situation would have been substantial. In any case, whilst alternative forms for the Guarantee were contemplated, they were not seriously considered since they, in the judgment of the authorities at the time, posed greater risks than benefits.

If accurate information on banks' exposures had been available at the time it seems quite likely to the Commission that a more limited guarantee combined with a state take-over of at least one bank might have been more seriously contemplated. Indeed, on the basis that such information had been available, banks could have been directed to raise substantially more private capital well before end-September 2008. As it turned out, however, the Government was advised that banks' insolvency risks were small relative to liquidity risks and it was eventually decided not to consider nationalisation. This proved to be only a temporary reprieve, however. After a series of insufficient government actions and initiatives, Anglo was nationalised on January 19, 2009 following the disclosure of significant governance failings. Shortly afterwards, the solvency implications of several banks' excessive property exposures started to emerge.

Some Lessons

Since the international financial crisis started, regulations have been tightened and institutional arrangements changed both in Ireland and in a number of other countries. A large number of groups, both national and international, have provided insightful analysis and recommendations on how to enhance the prospects for financial stability.

It is not the intention of the Commission to insert this Report into that wide arena. However, the Commission's work has highlighted some potential lessons from the banking crisis in Ireland that appear relevant from the point of view of reform; it seems only reasonable to offer them for potential wider consideration.

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. It must become respectable and welcome to express professionally argued contrarian views; neither this crisis nor many others have been or will be foreseen by the consensus view of professionals or managers. One way might be to regularly assess “worst case” scenarios relating to proposed strategies and forecasts, with a strong emphasis on using historical and international experiences. Additionally, lower-level staff could be more frequently consulted on implementation issues and their implications.

To help promote an even greater awareness of risks, such analyses need to be shared with all relevant parties; while this should lead to remedial action it need not, however, necessarily require open public discourse. 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.

Furthermore, authorities as well as bank boards and management need to remain particularly vigilant and professionally suspicious during extended good times. Nevertheless, history indicates that this is unlikely to be the case, in practice, for a number of reasons. Thus, 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. The economic size of the country and the sovereign as well as moral hazard considerations should affect the extent of such constraints. In addition, in order to slow a renewed “procedures creep”, banks should consider establishing internal, hard voluntary lending limits which they would make difficult to change or circumvent.

Also, the selection of management and board members in both responsible authorities and banks may need even more attention than before. 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.

Additionally, 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. A consistent message of the bankers interviewed by the Commission has been that money is only part of their work incentive. For people serious about professional public service, money should be even less of an incentive.

picture of the financial market. Failure to perform either of these tasks is, in the Commission's view, difficult to reconcile with the responsibilities of an independent CB.

4.5 The Department of Finance Pre-Crisis (2003 to mid-2007)

4.5.1 The Commission's Terms of Reference require it to examine the relevance of any advices or directions given by the DoF to the CB and the FR in relation to their supervisory role. In seeking to address this area, the Commission felt it necessary to examine the broader policy advice of the DoF over the Period in order to establish: (i) whether the DoF had concerns about growing macroeconomic imbalances and downside risks to the economy; (ii) whether such concerns were seen in terms of a threat to financial stability; (iii) how active and insistent the DoF generally was in its advice to Government, and (iv) what impact the DoF staff may have had on financial developments through its interaction with the CB and the FR.[114]

Advice on Economic Policy[115]

4.5.2 The DoF was generally conscious of the need to rein in both general government expenditure and tax reliefs that favoured the property market. For example, a 2004 brief prepared for the new Minister for Finance urged restraint in terms of growth in expenditure and tax reliefs and emphasised the need for base-broadening taxation measures. It also stated that competiveness should be maintained by controlling the domestic cost base and indentified the need for capacity to respond to economic shocks.[116] However, the brief was silent in relation to credit growth.

4.5.3 The ability of the DoF and the Minister for Finance to convince Government of the need to restrain expenditure growth was somewhat blunted by the fact that during 2003-2007 tax revenues were consistently higher than forecast, leading to a larger budget surplus than projected. As maintaining budgetary surpluses was seen as less important once public debt had reached relatively low levels,[117] the Minister for Finance was under considerable pressure to allow relatively high rates of expenditure to meet social and other priorities. Thus, current expenditure growth exceeded that of nominal GDP growth in all years since 2000, increasing particularly rapidly from 2005 onwards.

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[114] The Department is responsible for advising Government on economic and budgetary policy as well as the appropriate framework for financial services legislation. A further objective was the 'promotion of financial stability', which the DoF had determined to consist primarily of implementing legislative proposals. It appears that the Department saw its main role as helping to resolve an emerging financial stability problem rather than as assessing and pre-empting threats to stability.

[115] The 2010 report of an Independent Review Panel, "Strengthening the Capacity of the Department of Finance" gives more details on the economic policy advice which the Department provided to the Minister and Government. The Review Panel was appointed by the Minister for Finance to assess the DoF's performance over the past 10 years and, based on the lessons drawn from that assessment, to make recommendations for the future development, structure and resourcing of the Department.

[116] Some of the potential shocks it saw to the economy in 2004 were an increase in oil prices, an appreciation of the euro and the "impact on the economy of a fall in the number of houses being built from the current high level to a more sustainable level in the medium term".

[117] The general government debt/GDP ratio had fallen from just under 120 % in 1987 to 27.5 % in 2005 and to 25 % by 2007.

4.5.4 Despite the significant political pressures operating in the opposite direction, the advice on restraining expenditure should have been more vigorously articulated than actually was the case. Greater emphasis should have been put on the cyclically adjusted budget balance, given the fact that the composition of total revenue had changed significantly with a sharp increase in the share of cyclical taxes,[118] many of which were directly related to the credit-induced housing boom. At the same time, tax reliefs relating to property distorted resource allocation and undoubtedly contributed to overheating in the property market.

4.5.5 Both scoping reports document the extent of taxation incentives aimed at boosting the construction sector. Different classes of construction investment attracted sizeable tax subsidies (capital allowances and other tax reliefs) that extended over long periods. In addition to lowering the rate of stamp duties on several occasions, arrangements existed whereby stamp duty could be legitimately reduced or avoided entirely. Mortgage interest was deductible for tax purposes while capital gains for owner-occupiers on the sale of primary residences were not taxed. No domestic property tax (nor a possible alternative, a tax on imputed rental income) existed. As each of the above incentives artificially and unsustainably boosted the demand for property, a major review of these incentives was undertaken in 2005.[119] Although the majority of the review recommendations were contained in the 2006 Finance Bill, they were subject to transitional arrangements so as to avoid any sudden shock to the construction sector.

4.5.6 While the DoF identified various risks to the economy and to its budgetary forecasts, no single comprehensive analysis integrating all of these risks (including risks emanating from the financial sector) and assessing their implications for the economy into the medium-term was carried out. Had this been done annually, it might have led to an increased awareness in the DoF of the need to take policy actions to counteract some of the factors contributing to these risks.

Advice on Economic and Financial Stability

4.5.7 Internally, senior management in the DoF was updated regularly on housing developments (the main focus being on macroeconomic implications of a fall in housing output) and credit growth. Concerns with respect to credit growth date back to 2004 and subsequent updates noted credit growth was unsustainable, fast approaching the highest in the euro area, and driven by property market expansion. It was further noted that the construction sector's increasing share of credit made it vulnerable to a property downturn and that developments in house prices, relative to incomes and yields, could indicate that they were out of kilter with fundamentals. However, referring to the CB's 2005 Financial Stability Report, it was concluded in a briefing to the Minister that "all evidence is that systemic risk … to the financial system from a downturn in the property market is relatively limited". While concern was also expressed at official level about the impact on GDP and the budget balance of a fall in

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[118] Including corporation tax, stamp duty, capital gains tax and VAT.

[119] The review was commissioned by the Minister for Finance on foot of advice from the DoF to phase out some schemes and close certain loopholes; separate reviews were conducted by Indecon Consultants and Goodbody Consultants.

housing output towards a medium-term sustainable level, such a fall was viewed as a necessary adjustment in the housing market.[120, 121]

4.5.8 The Economic and Social Research Institute's (ESRI) Quarterly Economic Commentaries (QEC) and Medium-Term Reviews (MTRs) frequently examined the interaction between the construction sector and the real economy and briefings were provided to the Minister based on their findings. In briefing for the Minister on the 2005-2010 MTR, the Minister was informed that the continued rise in house prices posed a serious threat. The briefing for the Minister on the ESRI Spring 2007 QEC referred to the QEC's speculation regarding a housing bubble but advised that a soft landing was the most likely outcome. The Spring 2007 QEC also noted that if the astonishing growth in net foreign borrowing by Irish credit institutions since 2003 had been used to fund the ongoing boom in the housing market, the situation was not sustainable. This particular point does not appear to have been followed up by the DoF or brought to the attention of the Minister. Following the widely referenced article by Professor Morgan Kelly in the Summer 2007 QEC predicting a real house price fall, speaking notes prepared for the Minister concluded that house price increases in Ireland had been based on fundamental demographic and economic factors.

4.5.9 Following a communication from the Department of the Environment, Heritage and Local Government to the DoF in 2005, regarding the implication of 100% LTV mortgages on house price inflation and household indebtedness, DoF, after consulting with the FR, responded that while borrowers and lenders should exercise caution, it did not see any particular need to take action. However, in 2006, the DoF supported the increase proposed by the FR in the risk weighting for high LTV mortgages.

4.5.10 There is no evidence that the DoF was particularly concerned with prudential matters or in assessing any possible financial stability concerns relating to either individual institutions or the financial system collectively.[122] The annual Financial Stability Reports of the CB were brought to the attention of the Minister via briefings on the reports' main conclusions and via draft speaking points for his possible use. This material, however, essentially reflected the content of the reports themselves and did not contain any critical analysis.

Interaction with the Financial Regulator

4.5.11 As regards financial regulation, the DoF saw its primary role as providing the necessary legislative framework for the financial services sector. Also, the Minister for Finance approved the FR's annual budget. The Department's approach in dealing with the FR was based on the principle that the FR was independent of the DoF in respect of operational matters, a principle very much in line with international practice. The DoF did, however, have close contact with

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[120] According to a note of May 2005, a fall of 10,000 units in new house construction would reduce GDP by 0.5-1% and worsen the budget balance by 0.5% of GDP.

[121] There is evidence also of less sanguine outlooks in the DoF; however, it appears that such views unfortunately were not widely shared and they were not reflected in official views to the Minister.

[122] An exception arose in the case of Credit Unions, where the DoF was actively engaged, at the request of FR, with potential risks to stability.

the FR regarding the transposition into Irish law of various EU directives relating to the financial sector and regarding the implementation of the Government's broader "better regulation" agenda. While the FR's strategic plans were submitted to the DoF for comment and approval prior to their finalisation, comments or suggestions were in areas other than the exercise of its prudential supervisory functions.

4.5.12 One particular issue that deserves attention is the failure of the FR to require financial institutions to provide Directors' compliance statements.[123] This was a discretionary measure available to the FR from 2004 pursuant to an amendment to the Central Bank Acts. Given the FR's approach of relying on the boards and senior management of regulated institutions to act prudently, the ability to require a compliance statement would have been an extremely useful tool in increasing the accountability of management and boards for the assurances they may have given.

4.5.13 When the FR began to consider the issuance of a guidance paper on the proposed introduction of Directors' compliance statements in 2006, there were complaints from industry representatives. They argued that the planned legislation was inconsistent with the views of the Company Law Review Group and a decision was taken by the FR not to proceed with the matter at that stage. The Honohan Report (p. 50) noted that this decision was taken following a request from the DoF "not to proceed with the consultation process on the implementation of this requirement without engaging in further discussions with the Department". Following subsequent informal discussions, as well as written communications with the DoF, the FR decided to review the provision as part of the overall project to consolidate and modernise financial services legislation. [124]

4.5.14 When informed of this decision in early 2007, the DoF reminded the FR that the relevant power remained in the legislation and that the FR could always seek a compliance statement where circumstances warranted. Thus, the Commission could find no record that the DoF gave explicit instructions to the FR not to proceed with implementation of this provision.[125]

[123] The statement would confirm whether the regulated services provider had complied with its 'relevant obligations' during a specified period. In addition, external auditors would have been required to report on these compliance statements.

[124] In communicating publicly the decision not to proceed with the consultation process the FR (in 2007) noted that the most significant comments received during the informal consultation process were: "(i) The legislation is impaired by the absence of a materiality threshold and the extent of the confirmation required. The current wording requires the regulated entity to specify whether it has complied with its relevant obligation as opposed to confirming that they have in place appropriate 'arrangements or structures' to secure material compliance; (ii) The Company Law Review Group (CLRG) recommendation on Section 45 of the Companies (Auditing and Accounting) Act 2003 are not reflected in CBFSAI legislation;(iii) The Compliance Statement provision is not principles based and therefore inconsistent with the FR's approach; and (iv) This requirement would have a negative effect on Ireland's competitiveness. The FR considered that these remarks "called into question the practical application of the legislation".

[125] There remains, however, the impression that the DoF discouraged the FR from implementing this requirement.

Interaction with the Central Bank

4.5.15 As regards formal communications between the CB and the DoF in the pre-crisis Period, these appear to have been largely confined to routine matters. In particular, substantive discussions do not appear to have taken place directly between the DoF and the CB on the content of the various Financial Stability Reports, either before or after their publication. Before the Reports were finalised, the Governor regularly met with the Minister. However, no officials were present and there appear to be no records of the discussions in either departmental or CB files.[126]

4.5.16 That being said, the Secretary General of the DoF was *ex officio* a member of the CB Board throughout the period. Legally, the Secretary General was subject to the same confidentiality restrictions applicable to all CB board members; he was thus prohibited from disclosing any written or oral material obtained via the Board to others, including other DoF staff. However, it was generally believed that the views of the Secretary General reflected (or at least were consistent with) those of the DoF. From this perspective it would have been reasonable to conclude that if the DoF had major concerns on, for example, financial stability matters, these would have surfaced in the deliberations of the CB Board, including during the discussions of the joint Board Meeting (of the CB Board and the FR) that took place prior to finalisation of the joint Financial Stability Reports.

4.5.17 An important communication to the Minister was the annual CB pre-budget "Governor's letter" which was discussed by the Board before being issued. Throughout 2003-2008, the main concerns expressed in it related to the need to address the loss in competitiveness; it advised prudent wage policies and the avoidance of increases in taxes which would lead to an increase in inflation. The letter recommended a neutral budgetary stance; budgetary policy did not appear to the CB to be overly procyclical and this was reflected in the absence of strong warnings to change the stance of budgetary policy. Regarding housing, the letter's main concern was the increasingly large proportion of output devoted to construction and the potential risk this posed in the event of a housing downturn. However, it did not provide any indication as to the likelihood of such a downturn nor mention possible associated threats to financial stability. The 2005 and 2006 letters drew attention to the rapid increase in credit which was being channelled into the housing sector.

4.6 Crisis Management, Mid-2007 to September 2008

4.6.1 Chapter 8 of the Honohan Report describes in some detail the domestic and international background in the period leading up to the guarantee decision of September 29, 2008. The discussion which follows deals in turn with: (i) the main elements of the preparatory work undertaken by the authorities from mid-2007 onwards; (ii) the guarantee decision itself; and (iii) events during the period October 2008 – January 15, 2009.

[126] While the Governor reported to the Board of the Central Bank that he had met with the Minister, the Board minutes do not record any information as to what had transpired at the meetings.

R2 - Effectiveness of the Supervisory Practice (Central Bank, Regulator and Department of Finance)

R2b - Nature and effectiveness of the operational implementation of the macro-economic and prudential policy

Information Summary (Section 33AK)

Note: All references are aggregated.

Document category	Time period
• Pre-Budget letters from Central Bank of Ireland to Charlie McCreevy	1999-2003

Pre-Budget Letters

In September each year the Governor of the Central Bank issues a letter called the pre-budget letter to the Minister of Finance outlining the views of the Board of the Central Bank and Financial Services Authority of Ireland (CBFSAI), the letter for example in September 2003 is reviewing the Economy in 2003 for the Budget for value in 2004, it is presented in the Dáil in November of 2003.

"The 2004 Budget being framed against a most difficult economic background of low growth, rising unemployment, relatively high if declining inflation and severe pressures on competitiveness."
"Net exports are expected to be flat and unemployment will, unfortunately , increase"
"the Irish inflation rate remains at over twice the euro area average at a time when we are already at a serious competitive disadvantage"
"Irish competitiveness has been significantly eroded in recent years due to overheating in the economy"
"While the relatively slow pace of economic recovery will tend to automatically put pressure on the public finances, anything more than a modest increase in General Government Deficit relative to this year's outturn should be guarded against"

CB01B02 CB01103

In 2001 the events of September 11 had to be considered and the Central Bank reviewed its forecast for GNP growth from 4.5% to 3.5%.

> "The increase in activity is much weaker through this year, as clearly reflected in the recent Exchequer returns."
>
> "Our core inflation rate (at over 4 per cent) is still about twice the euro area average"
>
> "If we continue to have excessive domestic inflation we face the prospect of becoming a high cost country by the standards of EU generally"
>
> "Current demand is still running at a high level and the Central Bank continues to advise the lending institutions of the necessity to exercise prudence at all times"

CB01B01 CB00149

In the review of 2000 the Governor was surprised at the constant growth and was therefore cautious in his review for Budget 2001. They mention the possibility of a soft landing but also warn against a hard landing.

> "The consistently high economic growth up to now has surpassed all expectations. Past experience had led us to the Conclusion that such an extended period of high, growth would be unsustainable because of the inevitable overheating effects."
> "The Central Bank remains of the opinion that growth must inevitably slow-down in the not too distant future."
> "While a slow-down may be inevitable, there is no law which says that this must have disruptive effects on the economy, if it is managed carefully. It is the view of the Central Bank that there is every prospect of a so-called soft landing, provided there is a disciplined approach in the meantime to dealing with the problems of overheating, including, in particular, the threat of inflation and the erosion of competitiveness."
> "The signs of overheating, however, have now become increasingly evident and this reality must be a decisive factor in determining future policy."
>
> "Another source of concern to the Central Bank for some considerable time soaring demand for credit. Private sector credit growth is now running above 20per cent and this scale of growth is virtually without precedent in the

industrialised world. The Central Bank has introduced stress testing for the lending institutions and it has cautioned these institutions repeatedly on the necessity to make adequate provision for the impact of an economic downturn."
"House prices continue to rise excessively, adding to the demand for mortgage financing. It is difficult to see prices stabilising until supply is increased substantially……….Commercial property prices are also a source of concern."

"despite the strong surplus position, the case against an expansionary budget is convincing as this would heighten the risk of a **hard landing** for the economy. It is imperative to create awareness and appreciation that a loose budget policy would have unacceptable consequences down the road"

CB01B01 CB00146

In 1999 the Central Bank was praising the growth in the economy but was still cautious about continued level of growth and the threat to undermine the current success. Even in 1999 there were concerns of credit demand and the continuing house price increase would have social consequences. The Central Bank was upbeat about the large contributions towards provisioning for future pensions.

"Low interest rates have simply added fuel to the Irish economy, they have pushed up the demand for credit and they have been a contributory factor to the excessive rises in house prices."
"There are now distinct signs of overheating these are increasing and it would be unwise to downplay them. Wage increases over the past year in a number of sectors - and especially in the public sector give cause for concern."

"The overall growth in private sector credit was over 30 per cent year on year in June. This reflects demand in the economy generally and consumer confidence. It is too much."
"House prices continue to rise……….The persistent rise will have unhappy economic and social consequences"
"Given the continuing scale of growth and the increasing threat of overheating, a restrictive approach to the budget is highly desirable"

CB01B01 CB00145

Mr O'Gorman to see, please

Secretary General from David Doyle

Review of implications for staffing resources associated with the establishment of the Single Regulatory Authority

Background

1. The Government has already approved, in principle, the establishment of a Single Regulatory Authority and the Implementation Advisory Group, set up by the Government to advise on the establishment of the SRA has now submitted its report to the Tanaiste and the Minister for Finance. This report contains a set of recommendations in relation to the SRA and these have now to be considered by the Government. While it would be inappropriate to make assumptions about the detailed decisions the Government might take in relation to the Group's recommendations, it seems clear that there will be a Single Regulatory Authority and that overall responsibility for the Authority and for the 'policy' aspects of regulation of the financial sector as a whole will rest with the Minister for Finance. The only outstanding issue for resolution is whether the SRA will be part of, or separate from, the Central Bank.

This has implications for the staffing resources which the Department needs to allocate to this area. In addition to existing functions in relation to the financial services sector, there will be a considerable amount of work involved in the establishment of the SRA, both in terms òf developing an appropriate structure for the Authority where external consultation is likely to arise and in terms of the legislation needed to assign the relevant functions from existing regulators to the SRA. Furthermore, the assignment of overall responsibility for the SRA to the Minister for Finance means that general responsibility for the insurance industry, credit unions and for the oversight of consumer protection functions in the financial services area at large will pass to the Department from the Department of Enterprise, Trade and Employment. A detailed consideration of these issues is given later in this submission.

Current Staffing Levels

2. **Department of Finance**
Responsibilities in relation to the overall financial services sector in the Department of Finance are primarily handled in Finance Division where a Principal Officer devotes about two-thirds of his time to the area, backed up by 2 Assistant Principal Officers and 2 Administrative Officers. These staff are currently responsible for areas such as banking supervision, related EU Directives, banking legislation, servicing the EU Banking Advisory and High Level Securities Supervisors Committees, the Stock Exchange, Investment Intermediaries, investor compensation, EU policy on investment services, capital adequacy, and dormant bank accounts. In addition, issues related to Central Bank profits and reserves are addressed by another area within Finance Division.

The other main area of activity of the Department in relation to the financial services sector relates to the IFSC, where a section comprising a Principal Officer, 4 APs/Inspectors of Taxes and 2 AOs, currently processes applications for IFSC licences and deals with general policy in relation to the Centre.

3. **Department of Enterprise, Trade and Employment**

The Department of Enterprise, Trade and Employment is currently responsible for a range of functions relating to the financial services sector, which will transfer to the Department of Finance and/or the SRA. These include:

- all domestic and EU policy in relation to the insurance sector,
- the processing of EU Directives affecting insurance and legislation for the area;
- responsibility for the supervision of the insurance sector (most of which is now actually performed by industry sponsored self regulatory organisations) (SROs);
- responsibility for the Registrar of Friendly Societies which is the supervisory authority for credit unions, friendly societies and industrial and provident societies;
- responsibility for consumer protection generally, including in relation to the financial services sector. This includes responsibility for legislation in the area and the supervision of the Office of the Director of Consumer Affairs which has considerable functions in relation to mortgage and credit intermediaries, moneylenders, pawnbrokers, etc.

Based on figures supplied by the Department of Enterprise, Trade and Employment, it would appear that the staff complements currently assigned to the sections covering these responsibilities are as follows:

	PO	AP	HEO	EO	SO	CO	Other	Total
Insurance Section - Financial Supervision	1	2	5.5	5		2	1 Actuary 1 Acct.	**17.5** (17)
Insurance Section - Market Regulation	1	1	2	1		1	-	**6**
Insurance Section - Intermediaries	1	1	2					**4**
Consumer Protection Section	1	1	2	1		2.5		**7.5**

Other Staff:

4(i) In addition to the staff regulating financial services <u>within</u> the Department of

Enterprise, Trade, and Employment, some 14 administrative and support staff have been seconded to the Office of the Director of Consumer Affairs (ODCA) while the Registrar of Friendly Societies (RFS) has a staffing complement of 5 professionals and 17 admin/executive staff.

Some part of the staffing (more so at higher levels) must be devoted to policy and general oversight functions that will pass to the Department of Finance, but we can expect the Department of Enterprise, Trade & Employment to argue that people are not 'divisible'. Furthermore, it will be argued that these staff are mostly involved in supervisory work which will be transferred to the SRA. Thus, it is unlikely that any staff resources will be freed to deal with the policy aspects that will become the responsibility of the Department of Finance.

4(ii) **Central Bank**

While the Central Bank currently employs about 150 staff on regulatory issues, this work will move directly to the SRA and will not impact on the workload of this Department. However, in the event that the SRA is outside the Central Bank, there could be a lot of consultation work to be done.

5. **Transitional Staffing Requirements**

Once the Government has completed its deliberations on the recommendations of the Implementation Advisory Group, it will be necessary for the arrangements for the establishment of the SRA to be put in train. The principal transitional functions can be broken down between administrative and legislative arrangements. However, there will also be a need to provide a Secretariat for the Implementation Group proposed by the Department while the Department will also need to provide the resources necessary to allow the assumption of the functions being transferred from the Department of Enterprise, Trade and Employment, the ODCA and the RFS including EU-related activities.

(i) Administrative Arrangements for the SRA

This Department will have responsibility for policy in relation to the arrangements for the establishment of the SRA. If the Government's decides to adopt the "greenfield" option, then the Department will be involved in the establishment of a completely new organisation possibly employing over 200 staff - on a commercial SSB status. While the interim SRA Board, and the Chief Executive thereof, will have the main general responsibility, this will mean Departmental involvement in relation to the arrangements on a wide range of areas.

If the Government were, instead, to opt for a structure which kept the SRA under the umbrella of the Central Bank, then these establishment issues would be more easily addressed (e.g. it is assumed that existing Central Bank grading, terms and conditions, pension arrangements, etc, would apply).

(ii) Legislative Requirements

The establishment of the SRA will require legislation which, based on the recommendations of the IAG, will need to (a) provide for the operating structures of the SRA, including the power to levy charges on regulated bodies, and (b) re-assign existing responsibilities for regulation of the financial services sector to the SRA from those bodies to whom it is currently assigned. The legislation will also need to cover the establishment of the statutory Ombudsman scheme for the sector and the Tribunal recommended by the IAG as well as modifying some existing enactments to ensure compatibility with the new arrangements.

(iii) Secretariat to the Implementation Group

Throughout the transition phase, the Implementation Group proposed by the Department will have to meet very regularly and monitor progress on all aspects of the establishment of the SRA. It will be necessary for this Department to co-ordinate the work of this Group and to provide whatever back-up is required.

(iv) Other

During the transition phase, the Department will, in addition to the functions associated with the establishment of the SRA, have to continue to discharge its existing functions in relation to the financial services sector (which as indicated above requires the resources of most of a Principal Officer Section). Furthermore, the Department will have to take over responsibility for the policy aspects of those areas currently handled by the Department of Enterprise, Trade and Employment (including the ODCA and RFS). From a practical point of view, it would appear to be necessary that the assumption of policy functions from D/ETE will have to happen on a phased basis commencing almost immediately.

Finally, the IAG has recommended the establishment of a Standing Committee, chaired by this Department and comprising representatives of the SRA and the Central Bank. This is only applicable in the Greenfield site model. If this is adopted and in the interests of a smooth and efficient transition, it would probably be wise to initiate this Committee on an informal basis from an early date (possibly with the participation of the D/ETE on a temporary basis). The organisation and co-ordination of the functions of this Committee will mean additional work for the Department on an ongoing basis.

6. **Definitive Staffing Arrangements**

Once the transitional phase is completed, i.e. when the SRA legislation has been enacted and the Authority is operating, the staffing requirements will change again. Those staff that had been engaged in functions of a purely transitional nature would be available for other functions. However, some significant work will remain to be done at that stage. Perhaps the most important task will be the consolidation of the regulatory regime into a single piece of legislation (which the IAG recommended should be left until after the establishment of the SRA given the complexity of the issues involved). In addition, there is likely to be an ongoing legislative burden given the increasing pressure for regular, perhaps biennial, Financial Services Sector Bills. This work would be in addition to that, including EU-related activities, associated with the political responsibility of the Minister for all financial services regulation and consumer protection

7. **Re-deployment within Department**

It will be critical that the staff deployed in this area be familiar with the financial services sector from day one. Instead of simply pressing that a number of additional posts be created, the possibility of re-deploying staff from within the Department should be looked at. In this context, IFSC Section staff are familiar with the financial services sector.

Budget and Economic Division has been consulted and has advised that IFSC Section will continue to have a significant workload at least for the rest of this year and through next year's Finance Bill for which the existing staff will be needed. The situation will be reviewed towards the end of the year in the light of experience, but there will undoubtedly be continuing functions relating to the IFSC which the Department will have to discharge for the forseeable future.

9. **Conclusions**

With the establishment of the SRA, whether as a a “greenfield” operation or as part of the Central Bank, there will be a very significant increase in the staffing requirements of the area. Firstly, to get the SRA up and running via a "transfer of functions and establishment” Act. Secondly, to deal on an ongoing basis with the broader policy issues associated with the areas to be transferred to the SRA (e.g. prudential regulation of insurance sector and of credit unions and consumer protection issues of the financial services area generally). Thirdly, to deal with ongoing EU business - draft directives and so on. Fourthly, to consolidate the legislation in the area.

While we can look to the Department of Enterprise, Trade and Employment and the Central Bank for some help on this work, the reality is that we need to plan on the basis of, for the most part, dealing with it ourselves. It may be possible to take advantage of a redeployment of staff from IFSC Section but this option will only arise, if at all, in the longer term.

While it is not possible to determine the number of staff currently devoted to the policy issues related to the financial area within the D/ETE, ODCA and RFS it is likely to be significant and will not in any way be diminished by the establishment of the SRA. On the contrary, the heightened public awareness of the role of the State in regulation of this area could lead to an increased focus on the area with a consequential impact on the demand for improvements, etc. There appears to be compelling evidence that the workload associated with these new functions cannot be carried by the existing staff assigned to the regulatory area in Finance Division. While these functions may only pass to this Department formally once the SRA is established, the Department needs to gear up so that it can deliver the appropriate level of service from the outset. Accordingly, it is recommended that a new AP and AO/HEO section be established to deal with this area immediately and that the first function of this section should be to conduct an assessment of the long term needs of the Department in this respect. Given that the D/ETE has to process legislation in relation to the regulation of insurance intermediaries before the SRA is established and this Department formally accepts responsibility for the insurance sector, there may be merit in seconding an AP from this Department to the relevant section of the D/ETE to assist in the processing of that legislation since responsibility for it will pass to this Department almost immediately following enactment.

While the analysis above of the tasks arising during the transition phase also covers other tasks, it is envisaged that these would be covered by a combination of the existing resources and the additional resources recommended above. However, given the uncertainty about the associated workloads for each section, the position would need to be kept under close scrutiny to ensure that the Department is able to discharge its responsibilities efficiently and effectively at all times.

The foregoing proposals involve the establishment of 3 new AP sections within the Department immediately while there will also be a corresponding increase in the workload at Principal Officer level. Given that the Principal Officer already involved in the regulatory area is already fully employed on existing functions, it is further recommended that an additional PO be assigned to the area. Additional clerical support would also be needed.

____
David Doyle

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IRELAND'S HOUSING BOOM: WHAT HAS DRIVEN IT AND HAVE PRICES OVERSHOT?

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Abstract

Ireland's housing boom: what has driven it and have prices overshot?

The Irish housing market is very buoyant. The housing boom is driven by strong economic growth, dynamic demographics and low interest rates. However, large tax advantages and relatively lenient credit policies by banks have also played their part, and prices may have become overvalued. To the extent that high house prices reflect favourable tax treatment, they may lead to economic inefficiencies by drawing excessive resources into residential construction. While a soft landing appears the most likely prospect, a disorderly correction of house prices would pose risks for macroeconomic and possibly financial stability. In this context, one policy lever available to the government would be a phased removal of the tax advantages associated with housing. In addition, banks should remain cautious in their lending and provisioning policies.

This paper relates to the 2006 Economic Survey of Ireland (www.oecd.org/eco/surveys/ireland).

JEL classification: E2; R21; R31.

Key words: House prices; housing market; residential construction; property tax.

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Résumé

L'envolée du marché irlandais du logement

Le marché de l'immobilier est très dynamique en Irlande. L'essor du logement s'explique par la forte croissance économique, la dynamique démographique et la faiblesse des taux d'intérêt. Cependant, les importants avantages fiscaux et les politiques de crédit relativement libérales des banques ont aussi joué leur rôle et les prix sont désormais peut-être surévalués. Dans la mesure où les prix élevés de l'immobilier reflètent un régime fiscal favorable, ils peuvent conduire à des inefficiences économiques en attirant des ressources excessives dans la construction résidentielle. Tandis qu'un atterrissage en douceur apparaît très probable, une correction désordonnée de ces prix ferait peser des risques sur la stabilité macroéconomique, voire financière. Dans ce contexte, un des leviers d'action à la disposition des autorités serait une suppression graduée des avantages fiscaux associés au logement. En outre, les banques devraient être incitées à faire preuve de prudence dans leurs politiques de prêt et de provisionnement.

Ce document de travail se rapporte à l'Étude économique de l'Irlande 2006 (www.oecd.org/eco/études/irlande).

Classification JEL : E2 ; R21 ; R31.

Mots clés : Immobilier ; marché du logement ; construction résidentielle ; taxe foncière.

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Ireland's housing boom: what has driven it and have prices overshot?

by David Rae and Paul van den Noord[1]

House prices across the industrialised world have surged since the mid-1990s – with the notable exceptions of Germany and Japan which are both still grappling with the aftermath of real estate busts in the early 1990s. In many countries, housing demand is underpinned by an easy monetary stance (Otrok and Terrones, 2005), while over a longer period tight zoning regulations have exacerbated the upward movement in property prices in and around growth centres (Glaeser *et al.*, 2005). Yet Ireland stands out by its extraordinarily strong increase in house prices over the past decade. It is important to understand what has been driving this increase in order to judge the likelihood, timing and size of any fall. A sharp decline in house prices would be a concern for homeowners and could have serious consequences for macroeconomic and financial stability. Meanwhile, the booming market combined with the tax treatment of housing may be impacting on the economy's productive potential by diverting a large amount of resources into residential construction. It may also be acting as a brake on labour supply by making it more expensive for people to immigrate and settle in the country.

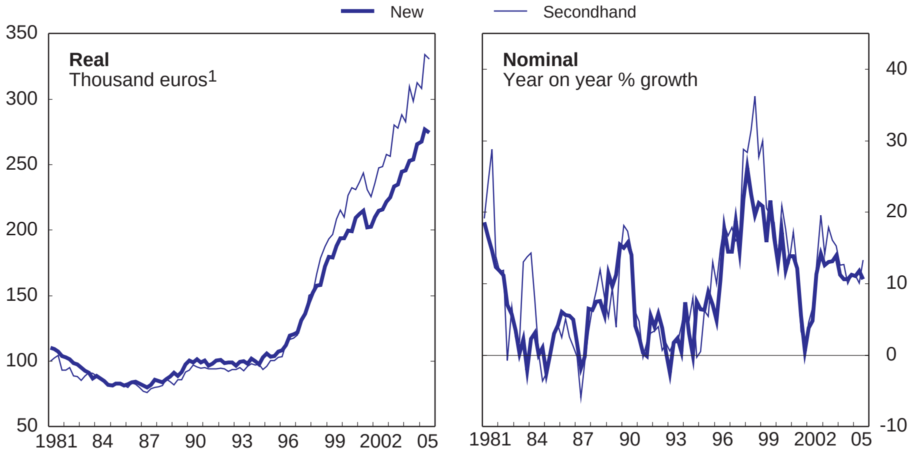
This paper argues that *most* of the increase in Irish house prices is justified by the economic and demographic driving forces. It should be remembered that in 1993 the average Irish house cost a mere € 75 000, which was extraordinarily low for a European country. Since then, remarkable growth in incomes, low interest rates, strong population growth, especially among the younger house-forming age groups, a surge in immigration and changing living patterns have all contributed to the boom. However, prices have probably over-shot to some extent, and taxation may have contributed to fuelling the speculative boom. Looking ahead, the most likely scenario is that prices stabilise and the housing market stays flat for some years. But there is some risk that house prices will fall, and the market is certainly exposed should the economy be hit by a negative shock. This chapter looks at the past and the future of the housing market and discusses the role that policy can play going forward.

Forces driving the housing market

Ireland's house prices have risen dramatically since the mid-1990s. From 1995 to 2005 the price of second-hand houses more than tripled in real terms (Figure 1, left panel). House price inflation eased temporarily in 2001 but it has reignited since. Compared with other countries, the Irish housing boom has been extraordinarily vigorous: both in real and nominal terms the increase in house prices since the mid-1990s has been the highest in the OECD, with the United Kingdom and Spain ranking second and third respectively.

1. This paper was originally prepared for the *OECD Economic Survey of Ireland* published in March 2006 on the responsibility of the Economic and Development Review Committee. The authors are grateful to colleagues in the OECD for their helpful comments, especially Boris Cournède, Peter Hoeller, Andrew Dean and Val Koromzay. Special thanks go to Desney Erb for her technical assistance. The authors can be contacted at david.rae@oecd.org and paul.vandennoord@oecd.org.

Figure 1. House price growth remains high



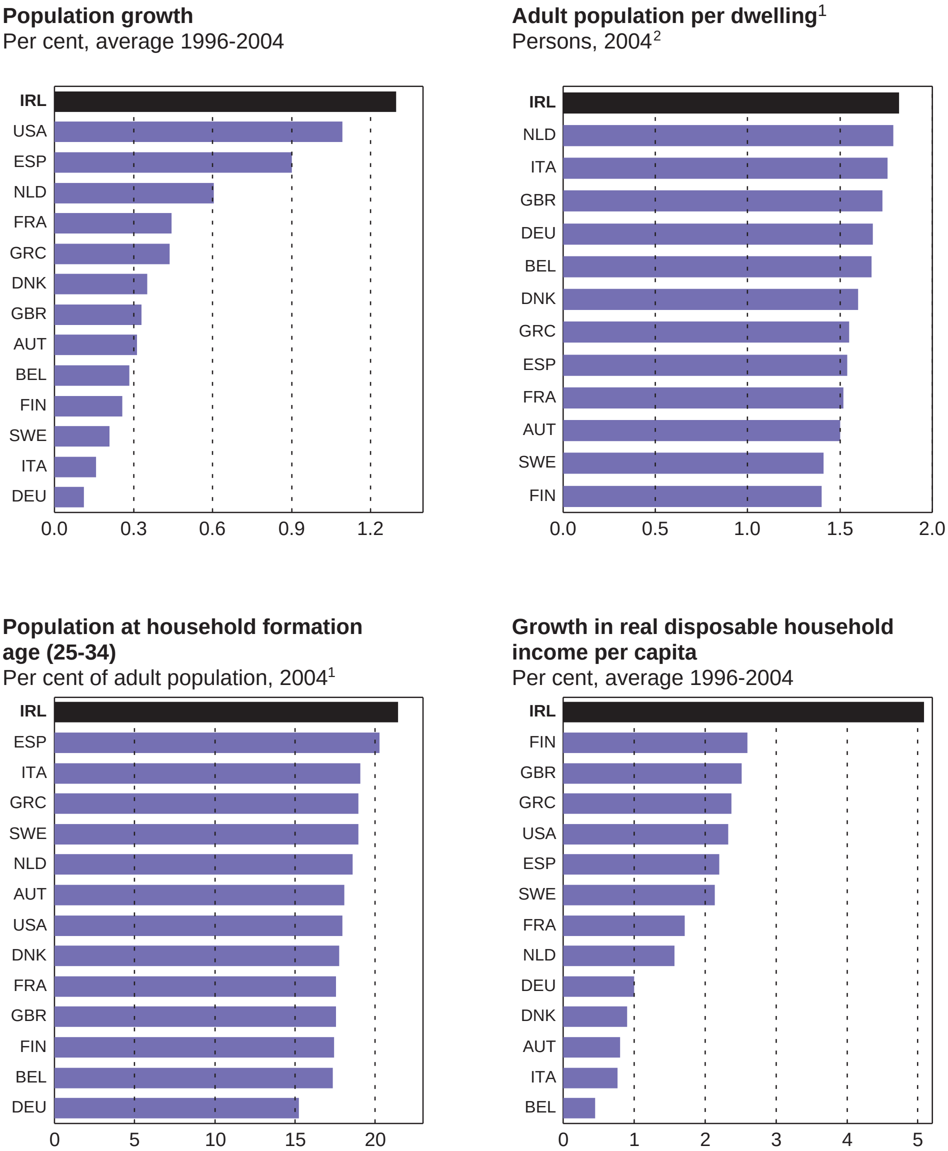
1. Nominal prices deflated using the harmonised consumer price index (base 2005).

Source: Department of the Environment, Heritage and Local Government, *Quarterly Housing Statistics* and OECD, Main Economic Indicators database, May 2006.

More favourable demand factors in comparison with developments elsewhere have surely played a role in shaping the buoyant price developments in Ireland. Growth in real disposable income since the mid-1990s has been stronger than in any other industrial country and real interest rates were among the lowest (Figure 2). The decline in inflation has also contributed by front-loading mortgage repayments. Furthermore, demographic trends were particularly favourable to housing demand in the 1990s, including strong population growth, a sharp fall in household size from a high level, a rapid acceleration in the growth of population in the household formation cohort and sizeable net immigration. Other demographic developments include the increase in the number of double income households and higher divorce rates. Another factor is the number of baby boomers investing in the buy-to-let market because of increasing worries about inadequate pension provisions for retirement.

In addition, the tax treatment of housing in Ireland has been more favourable for home ownership than in most other EU countries (van den Noord, 2005). This is reflected in a low user cost of capital. The user cost for homeowners is analogous to the cost of rental accommodation for tenants. It includes the after-tax mortgage interest rate net of capital gains, the opportunity cost associated with equity financing (usually the after-tax deposit rate), property tax (if any) and depreciation. There have been extended periods when the user cost has been negative, in particular in the late-1970s and from the mid-1990s onwards, implying a strong incentive to invest in housing.[1] The main driving factor keeping the user cost negative has been the untaxed capital gains (on owner-occupied homes), whereas the importance of income tax deductions has diminished with the gradual decline in marginal income tax rates and a series of other tax reforms (Box 1). Since taxation of capital gains has an important negative influence on the user cost, its absence could have acted as a catalyst for the upward spiral in house prices.

Figure 2. Forces shaping house prices



1. Adult population covers persons from age 20 onwards.
2. 2003 for Austria, Finland, France, Greece and Italy.

Source: OECD (2005), Labour Force Statistics and Economic Outlook 78 databases; European Mortgage Federation (2005), *Hypostat 2004*.

Box 1. Tax breaks for housing and policy flip-flops

Ireland has some of the most generous tax provisions for owner-occupied housing, largely because it is the only OECD country that allows households a tax deduction for mortgage interest payments at the same time as *not* taxing property values, capital gains or imputed rent (Barham, 2004 and van den Noord, 2005).[1] The following provisions are the most important ones:

- Ireland introduced a residential property tax in April 1983. The rate was 1½ per cent for properties above a certain value and where the owner's income exceeded a certain rate. The 1994 Budget adjusted these price and income thresholds, but those measures were scrapped in the following budget, with a return to the previous system. The property tax was abolished altogether two years later. A private residence of up to one acre is exempt from capital gains tax, which is large enough to cover virtually all houses.

- Mortgage interest can be deducted against income tax. Prior to 1974 there was no limit as the full cost of mortgage interest could be deducted at the marginal tax rate. A ceiling was introduced in 1974 and increased on two occasions, in 1993 and 2003. Both these increases followed prolonged periods in which interest repayments normally exceeded the ceiling. Mortgage interest relief was phased in at the standard rate of tax (as opposed to the marginal rate) in 1994. This saw a reduction in the benefit accruing to homeowners with the deductibility rate falling from 48% in 1993 to 26% in 1997. Meanwhile, the imputed rental income is not taxed, unlike rental income to a third party.

- A package of tax measures was introduced in 1998 in an attempt to deflate what appeared to be a housing bubble. Stamp duty on new houses that were not owner-occupied was increased, while stamp duty on second-hand houses was reduced; capital gains tax on disposals of qualified residential land was reduced; and tax breaks for rental income were removed. These were successful in stopping house price inflation – possibly too successful, as they were reversed in the 2002 Budget. Meanwhile, another package of measures was introduced in 2000 in order to discourage investors from buying rental property. This included a 9% stamp duty on the purchase of property for rent. That also worked but had the predictable side effect of driving up rents, so it was abolished just a year later. Stamp duty was changed again in the 2005 Budget, this time lowering the tax for first-time buyers.

1. Finland, Portugal and Spain are the only other countries which, like Ireland, give a tax deduction for mortgage interest payments but do not tax imputed rent or capital gains on the principal owner-occupied dwelling. However, all three have municipal taxes on property values ranging from 0.4% to 1%. The size of the tax bias in Ireland has been reduced over time as the ceiling on mortgage interest deductibility has not kept pace with the increase in house prices. Updating the estimates by van den Noord (2005) shows an overall tax wedge of –0.57% for the first seven years and –0.36% thereafter, giving Ireland the fifth-largest tax bias in the EU15.

Access to mortgage finance is also less restrictive in Ireland than elsewhere, especially compared with continental Europe (Table 1). Financial market liberalisation during the 1980s and 1990s has supported demand by allowing a rapid expansion in credit. The full effects of liberalisation were beginning to be felt in the mid-1990s, just at the time when housing demand was growing fast. Loan-to-value ratios have risen from an average level of 60% in the 1980s to around 80% at present. The trend towards securitisation of bank loans is another factor. In general, securitisation makes interest rates on new borrowing more responsive to financial market developments. It also enhances competition, which lowers the costs of taking out a mortgage and makes it easier for households to access their capital through housing equity withdrawals (Catte *et al.*, 2004). The adoption of the euro has been another important influence in helping to increase the elasticity of supply of mortgages. The exchange rate risk disappeared, removing one of the obstacles to the freer flow of funds within the euro area. This means that the domestically-based Irish banks have a hugely expanded pool of funds available. The removal of the exchange rate risk premium, by lowering interest rates, has also acted to stimulate demand for mortgages. Finally, most mortgages in Ireland are variable rate loans, so the reduction in short-term interest rates (until recently) has further boosted demand.

Table 1. Mortgage and housing market indicators

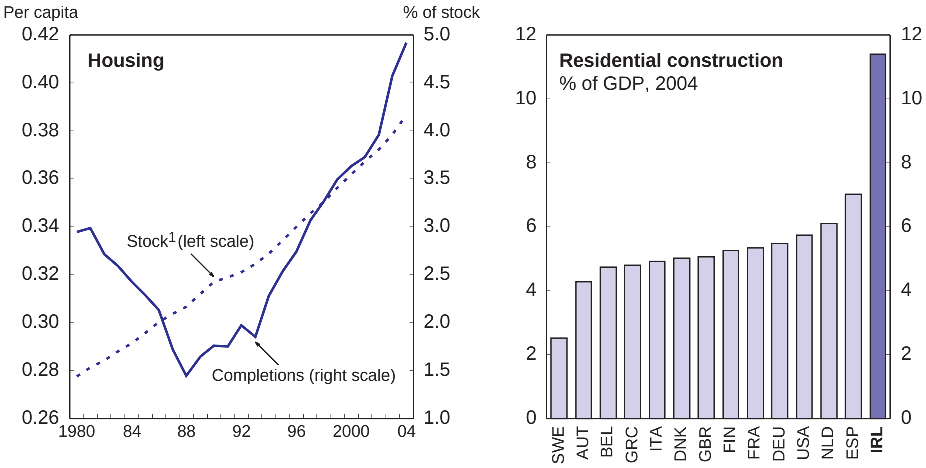
	Residential mortgage debt (% of disposable income, 2003)[1]	Typical loan-to-value ratios of new loans (%)	Typical loan term (years)	Variable interest rates (% of all loans, 2002)[2]	Securitisation of mortgages	Home ownership rate (%, 2002)[2]
Ireland	**106**	**70-100**	**20**	**85**	**Limited**	**77**
Australia	120	90-100	25	73	Yes	70
Austria	..	..	20-30	..	..	56
Canada	77	70-80	25	25	Yes	66
Denmark	188	80	30	15	Yes	51
Finland	71	75-80	15-18	97	Limited	58
France	40	80	15	20	Limited	55
Germany	83	70-80	25-30	72	Limited	42
Italy	20	50	15	56	No	80
Japan	58	80	25-30	..	No	60
Netherlands	208	87	30	15	Yes	53
New Zealand	129	..	..	..	..	65
Norway	24	70	15-20	..	No	77
Portugal	33	..	15	..	..	64
Spain	67	..	15	75	Yes	85
Sweden	98	80-90	<30	38	Limited	61
United Kingdom	105	75	25	72	Yes	69
United States	78	80	30	33	Yes	68

1. 2002 for Norway and Portugal, 2005 estimate for Ireland.
2. Or latest year available.

Source: OECD (2005), *OECD Economic Outlook*, No. 78, Paris; OECD (2004), *OECD Economic Outlook*, No. 75, Paris, June; Tsatsaronis, K. and H. Zhu (2004), "What Drives Housing Price Dynamics: Cross Country Evidence", *BIS Quarterly Review*, Bank for International Settlements, Basel, March; Ahearne, A.G. *et al*. (2005), "House Prices and Monetary Policy: A Cross-Country Study", *International Finance Discussion Papers*, No. 841, Board of Governors of the Federal Reserve System, September; Central Bank and Financial Services Authority of Ireland.

The rise in housing demand triggered a strong response in supply, which again is unprecedented by international standards (Figure 3). House construction and residential permits per capita are among the highest in the OECD. Around a third of the housing stock is younger than ten years old. Half of the stock is detached houses, with apartments accounting for just 6%. The enormous increase in housing supply was accompanied by significant increases in real construction costs and land prices. The significant cost increases did not deter the supply of housing, which was aided by more relaxed zoning rules. Yet, despite the massive increase in the housing stock, it will almost certainly increase further in the medium term (even ignoring the effect of population growth) given that in Ireland there are significantly more adults per dwelling than in other OECD countries. If preferences in Ireland were similar to those in other EU countries, this would, *ceteris paribus*, lead to falling numbers of (adult) persons per dwelling. This gap has undoubtedly been a factor in the buoyant demand for housing and a driving force behind the escalation of house prices, and is likely to act for several more years. Indeed, the high cost of accommodation in Ireland may be discouraging people from forming an independent household (Fitz Gerald, 2005).

Figure 3. Residential construction is booming



1. OECD estimate of stock of permanent dwellings, end of year.

Source: Department of the Environment, Heritage and Local Government (2005), *Annual Housing Statistics, Bulletin 2004*, The Stationery Office, Dublin and OECD (2005), Economic Outlook 78 database.

Are house prices overvalued?

The question of whether the fundamentals can fully explain the Irish housing boom can be addressed by different methods. One approach is to use an econometric model and see if house prices deviate from their long-term equilibrium level. Another is to treat housing as an asset that reflects the discounted present value of its future earnings. However, these indicators need to be complemented by other evidence such as price-to-rent ratios, measures of affordability and benchmarking against other countries. A range of evidence is discussed below.

An econometric model of house prices

Econometric models can be used to estimate the "fundamental" price, as determined by demand factors, such as real disposable income and real interest rates, and supply factors. A price level in excess of the fundamental price could be a sign that prices are inconsistent with demand and supply conditions and instead may be driven by irrational expectations of future capital gains. In such a house price bubble, home buyers consider that a house that would normally be too expensive for them (or much more expensive than renting) is worth buying because they will be compensated by significant further price increases (Meen, 2000 and Case and Shiller, 2003).

After tracking each other closely for many years, the prices of new and second-hand houses began to diverge in the mid-1990s. Since 1995, average second-hand house prices have risen by around 340%, compared with 240% for new houses. The different trajectories are not surprising as the two types of housing are not perfect substitutes (for example, the average new house is smaller and further from the city centre) and the supply of new houses can expand more rapidly than existing dwellings, the supply of which is less elastic. Because the markets are so closely related but are not perfect substitutes, the prices of new and second-hand houses are modelled together in a joint estimation framework based on a cointegration error-correction approach. Long-run or equilibrium prices are assumed to depend on real per capita disposable income, *y*, the real after-mortgage interest rate, *r*, and the stock of each type of dwelling, *H*. The basic estimation framework is shown below:

$$p_t^{sh} / p_t^{c} = \alpha_1 + \beta_1\, y_t - \gamma_1\, r_t - \theta_1 \left(h_t^{sh} - pop_t^{25-44}\right) + \lambda_1 \left(pop_t^{25-44} / pop_t\right).$$

$$p_t^{new} / p_t^{c} = \alpha_2 + \beta_2\, y_t - \gamma_2\, r_t - \theta_2 \left(h_t^{new} - pop_t^{25-44}\right) + \lambda_2 \left(pop_t^{25-44} / pop_t\right).$$

where lower case letters denote natural logarithms, p^n is the price of new houses, p^{sh} is the price of second-hand houses and p^c stands for consumer prices, here measured by the core harmonised consumer price index (HICP; excluding food and energy). The housing stock, h_t, is based on a cumulation of housing completions net of depreciation (see Box 2 for a more precise description of the variables). In the estimation described below, the stock of new dwellings was not found to be a statistically significant determinant of the price of new dwellings, and therefore was dropped from the estimation. To some extent this is not surprising as supply is fairly elastic. The demographic variable (the share of the population that is around the household-formation age) is included to capture the hypothesis that a younger population is likely to put extra pressure on the housing market.

The two equations are estimated on quarterly data from 1977 to 2004 using the Seemingly Unrelated Regressions (SUR) estimator. Short-run error correction models are then estimated, again using SUR. The final results from the system are:

Second-hand house prices: long run

$$p_t^{sh} / p_t^{c} = \underset{(3.88)}{6.811} + \underset{(48.4)}{1.6883}\, y_t - \underset{(9.16)}{1.9289}\, r_t - \underset{(6.63)}{1.6785}\left(h_t^{sh} - pop_t^{25-44}\right) + \underset{(6.36)}{2.9862}\left(pop_t^{25-44} / pop_t\right)$$

New prices: long run

$$p_t^{n} / p_t^{c} = -\underset{(10.4)}{2.6130} + \underset{(57.6)}{1.5279}\, y_t - \underset{(14.8)}{2.0471} r_t$$

Second-hand prices: short run

$$\Delta\left(p_t^{sh} / p_t^{c}\right) = \underset{(0.16)}{0.0119}\Delta\left(p_t^{sh} / p_t^{c}\right)_{t-1} + \underset{(1.58)}{0.1127}\Delta\left(p_t^{sh} / p_t^{c}\right)_{t-2} + \underset{(3.47)}{0.2517}\Delta\left(p_t^{sh} / p_t^{c}\right)_{t-3}$$

$$+ \underset{(5.76)}{0.9916}\Delta y_t + \underset{(2.13)}{0.4052}\Delta y_{t-4}$$

$$- \underset{(6.405)}{0.4817} ECM_{t-1} + \underset{(4.37)}{0.3382} ECM_{t-1}^{new\ prices} + \underset{(3.35)}{0.0403} DUM$$

$$R^2 = 0.5127; \quad s.e. = 0.0238; \quad DW = 1.75$$

New prices: short run

$$\Delta\left(p_t^n / p_t^c\right) = \underset{(2.21)}{0.1584}\Delta\left(p_t^n / p_t^c\right)_{t-3} + \underset{(2.56)}{0.1939}\Delta\left(p_t^n / p_t^c\right)_{t-6} + \underset{(5.57)}{0.7948}\Delta y_t + \underset{(2.74)}{0.4171}\Delta y_{t-4}$$

$$- \underset{(2.82)}{0.1708}ECM_{t-1}^{negative} - \underset{(1.03)}{0.0598}ECM_{t-1}^{pos} - \underset{(1.11)}{0.00326} + \underset{(4.14)}{0.0408}DUM$$

$$R^2 = 0.4927; \quad s.e. = 0.0199; \quad DW = 1.81$$

The main findings are that:

- The long-run income elasticity is estimated to be 1.5 for new houses and 1.7 for second-hand houses. Both estimates are higher than the ones estimated by Fitz Gerald *et al.* (2003) and IMF (2004), which are 1.07 (for new houses) and 1.20 (for a weighted-average of new and second-hand houses) respectively. The demographic variable affects second-hand house prices in the expected way, but is not significant in the equation for new houses.
- The interest rate semi-elasticity is around –2.0 in both cases. This also is larger than estimates in other recent studies.
- The per capita housing stock has a significant negative impact on the price of second-hand houses.
- The short-run income elasticities are high in both equations, meaning that prices respond quickly to changes in household incomes.
- For new house prices, the error-correction coefficient is asymmetric. It implies that house prices rise more easily than they fall. More precisely, negative disequilibria (prices below fundamentals) tend to be corrected by a subsequent increase in prices. In contrast, if prices are above fundamentals they tend not to drop but to “wait for fundamentals to catch up” (see O’Donovan and Rae, 1997, for evidence of a similar effect in New Zealand).
- The error-correction coefficient for new house prices enters the equation for second-hand house prices with a positive sign. This means that disequilibrium in the market for new houses spills over into the market for second-hand houses.
- A dummy variable (DUM) was included to capture a confidence crisis in 2001 associated with the announced (but rapidly withdrawn) introduction of a flat-rate 9% stamp duty (to replace the existing progressive rate schedule with a top rate of 9%) and a 2% anti-speculative property tax. The coefficient implies that the policy change led to a temporary fall in house price inflation by around 10 percentage points, although it may also be picking up other factors such as the hit to confidence coming from the bursting of the high-tech bubble.
- In terms of the statistical properties of the equations: *a)* the fit is relatively good for such a volatile variable, with a standard error around 2% in both equations; *b)* the error-correction coefficients are relatively large and statistically significant, implying that the long run equations are cointegrated (this is confirmed by a direct ADF test of the residuals from the long-run equations); *c)* there are no signs of mis-specification from residual tests of autocorrelation, heteroscedasticity and non-normality; and *d)* the coefficient estimates are relatively stable over time.

Box 2. Description of the data

House prices are average sales prices recorded by the Department of Heritage and Local Government. They are not adjusted for quality or composition (an alternative quality adjusted index is constructed by TSB Permanent Bank but this starts only in 1996). They are deflated by the core HICP (HICP excluding food and energy). Series for the stock of dwellings and pre-tax mortgage interest rates have been provided by the Economic and Social Research Institute (ESRI). The total dwelling stock is based on summing up dwelling completion figures, adjusting for depreciation and benchmarking to census estimates in 1991, 1996 and 2002. This is split between new and second-hand houses as follows. The stock of new houses is estimated by summing completions (less depreciation) and assuming that 15% of new houses "fall" from the new to the second-hand market each year. That is, the half-life of a new house before it becomes part of the "established" or second-hand stock is approximately 4-5 years. The stock of second-hand houses is equal to the total stock (as estimated by ESRI) minus the new stock. The after-tax mortgage interest rate has been computed as the pre-tax mortgage interest rate multiplied by one minus the relevant marginal income tax rates as published in Barham (2004). The real after-tax rate is the nominal after-tax rate minus the core HICP inflation rate. Real disposable household income is taken from the OECD Economic Outlook database. Demographic variables (population by age) are from the Central Statistics Office.

An extended three-equation model was also tested. This had an additional equation for dwelling investment because the housing stock is likely to be an endogenous variable, and in particular to be a function of house prices. The additional equation did not materially alter the estimates in the house price equations so the results are not reported here (available on request from the authors).

Actual and fitted values are shown in Figure 4. The long-run equation can be used to estimate the fundamental price levels. The result, shown in Figure 5, suggests that house prices have been above their fundamental level since early 2003. By the end of 2004, given interest rates prevailing at that time, second-hand house prices were around 10% overvalued and new house prices around 20% higher than their fundamental level. If long-term interest rates were to return to a more reasonable estimate of their long run level (*i.e.* 2 percentage points higher than at the end of 2004) then the overvaluation would be 16% and 26% respectively.

In sum, the model and similar econometric estimates suggest that prices have overshot their fundamental value. It is worth noting, however, that around 80 to 90% of the increase in house prices since 1995 is justified by the fundamentals – rising incomes, lower interest rates, demographic factors, etc. The remainder appears to be speculative froth. All econometric models are subject to considerable uncertainty, due to modelling error, omitted variable bias and so forth, but the estimate from this model is broadly consistent with a similar analysis conducted by the IMF (2004). Some alternative econometric models presented in the Irish Central Bank's *Financial Stability Report 2005* show an estimated over-valuation ranging from essentially zero to more than 70%, highlighting that it is necessary to look at more than one indicator and to make judgements about which indicators may be more reliable than others. Alternative evidence is discussed below.

Figure 4. Actual and fitted house price growth

Per cent, annualised rate

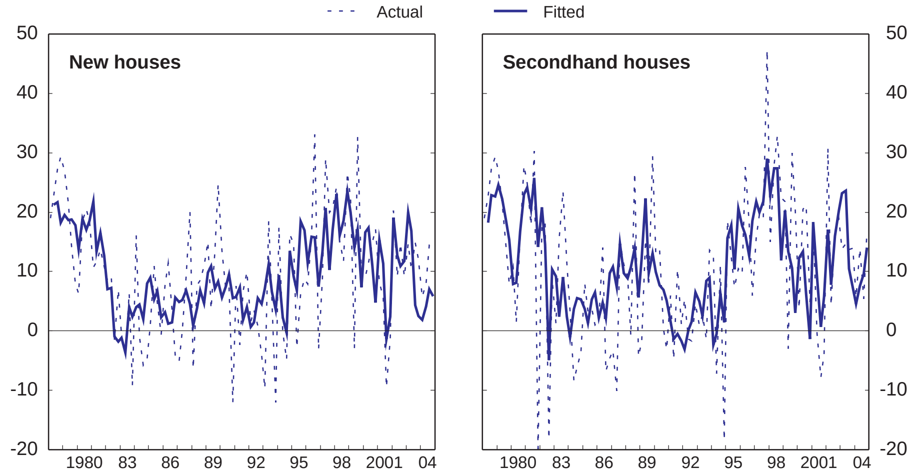
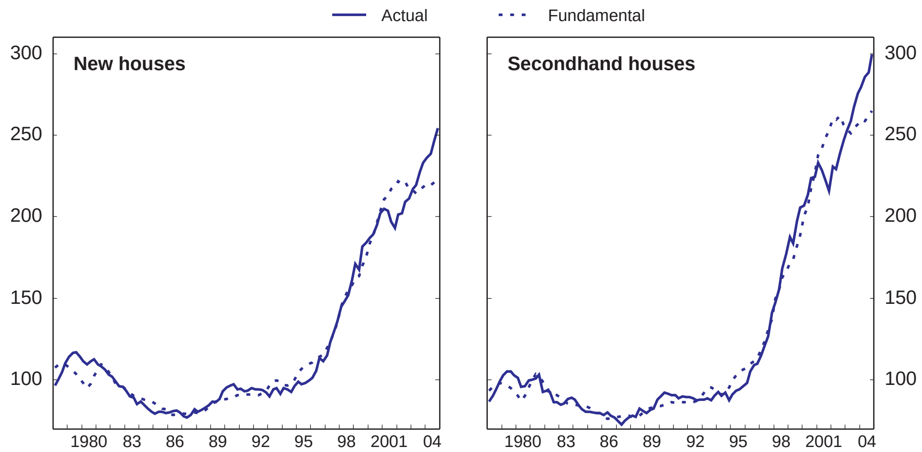


Figure 5. Actual and fundamental house prices

In thousand euros, real prices[1]

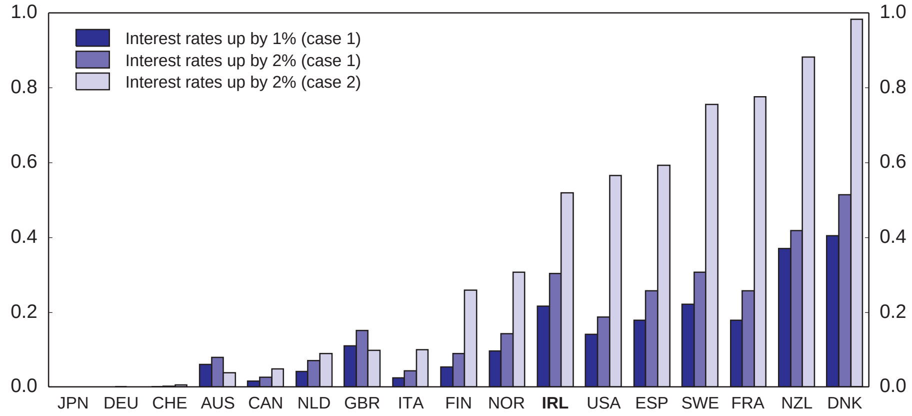


1. Nominal prices deflated using the harmonised consumer price index.

The probability that house prices are approaching a peak

Another way to look at the issue is to build a model that tries to predict house price peaks. Van den Noord (2006) constructs a cross-country probit model for 17 OECD countries in which the probability that real house prices are at a peak depends on past price increases, a measure of the deviation of prices from their trend, and real long-term interest rates. Historically, this model has performed reasonably well at predicting peaks. House prices have been moving up strongly in real terms since the mid-1990s in the majority of OECD countries, not just Ireland, and the current upswing is the longest of its kind in the OECD area since the 1970s. In the current cycle, real house prices have peaked in only two countries so far (Finland in 2000 and Australia in 2004), while they have slowed considerably in two other countries (the United Kingdom and the Netherlands). In most other countries, including Ireland, real house prices have

Figure 6. The probability that real house prices are nearing a peak[1]



1. Case 1 refers to a 100 basis point increase in interest rates from mid-2006 levels, at current real house prices. Case 2 assumes that real house prices continue to increase (or decrease) for another year at the pace observed in 2005 before the interest rate shock is applied. To call a peak it is required that real prices fall over a period of at least six quarters after having risen by at least 15% cumulatively over a period of six quarters.

Source: van den Noord, P. (2006), "Are House Prices Nearing a Peak? A Probit Analysis for 17 OECD Countries", *Economics Department Working Papers*, OECD, Paris, forthcoming.

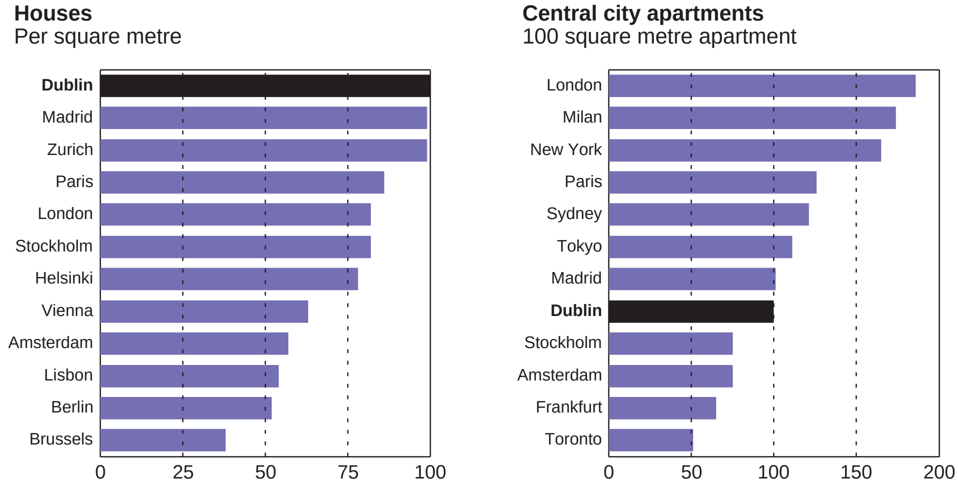
kept growing at a rapid pace or even accelerated. Simulations with the probit model suggest that housing markets in most countries would be resilient against a 1 or 2 percentage points hike in long-term interest rates if it kicked in at current real house price levels, the main exceptions being Denmark and New Zealand (Figure 6). However, the picture changes considerably if real prices are assumed to increase for another year at their observed 2005 pace in each country. In that situation, an increase in interest rates would raise the probabilities of a peak nearing to 50% or more also in Ireland, the United States, France, Spain and Sweden.

International comparisons

It is difficult to compare prices across countries because the size, quality, location and amenities of houses can differ substantially. Comparisons are a little easier if they are restricted to the major cities, but this does not solve the problem entirely. Bearing this in mind, the available evidence suggests that average prices in Dublin are higher than in comparable cities. In a comparison of average sale prices in 2004 across a dozen European cities, the price per square metre was higher in Dublin that everywhere else (Figure 7, left panel). Some further evidence comes from cost-of-living comparisons conducted by various private-sector consultancies. These usually focus on prices or rents of inner-city apartments typically bought or rented by business executives. Here Dublin does not stand out so dramatically (Figure 7, right panel).[2] This may be because rents are not especially high in Ireland but it may also reflect urban sprawl. Anecdotally at least, there is not a great deal of diversity in the housing stock. The centres of the main cities have not been taken over by apartment complexes and there is relatively little high-density in-fill housing. If preferences change and Irish people become more comfortable living in downtown apartments or in higher-density housing with no garden, then the distribution of prices may become more uneven: house prices in the central city may rise significantly relative to prices in the suburbs and city fringes. There is some evidence this may be happening already (Policy Exchange, 2005).

Figure 7. Average house prices

Dublin = 100, 2004



Source: OECD calculations based on data from ERA Immobilier (left panel) and The Economist Intelligence Unit (right panel).

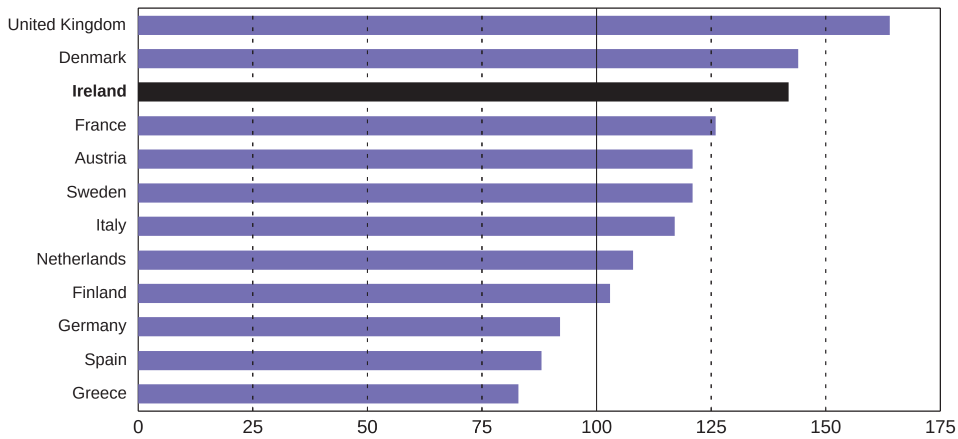
Another way to compare across countries is to look at broadly defined housing costs across countries. Figure 8 shows relative housing costs for several European countries, including house prices and rents as well as household operation and maintenance costs such as water, electricity and gas. In 1995, Ireland was less expensive than the United Kingdom but almost tied for second place with Denmark.

Owning versus renting and the "great ratios"

In a majority of countries, the ratios of prices to rents and prices to disposable income do not have strong trends when considered over long periods of time. The ratios may rise sharply during housing booms, but they usually fall back again through a combination of falling real house prices (*i.e.* a lower numerator) and rising rents or incomes (the denominator rising to catch up). In Ireland's case, the increase

Figure 8. Housing costs are high by international standards

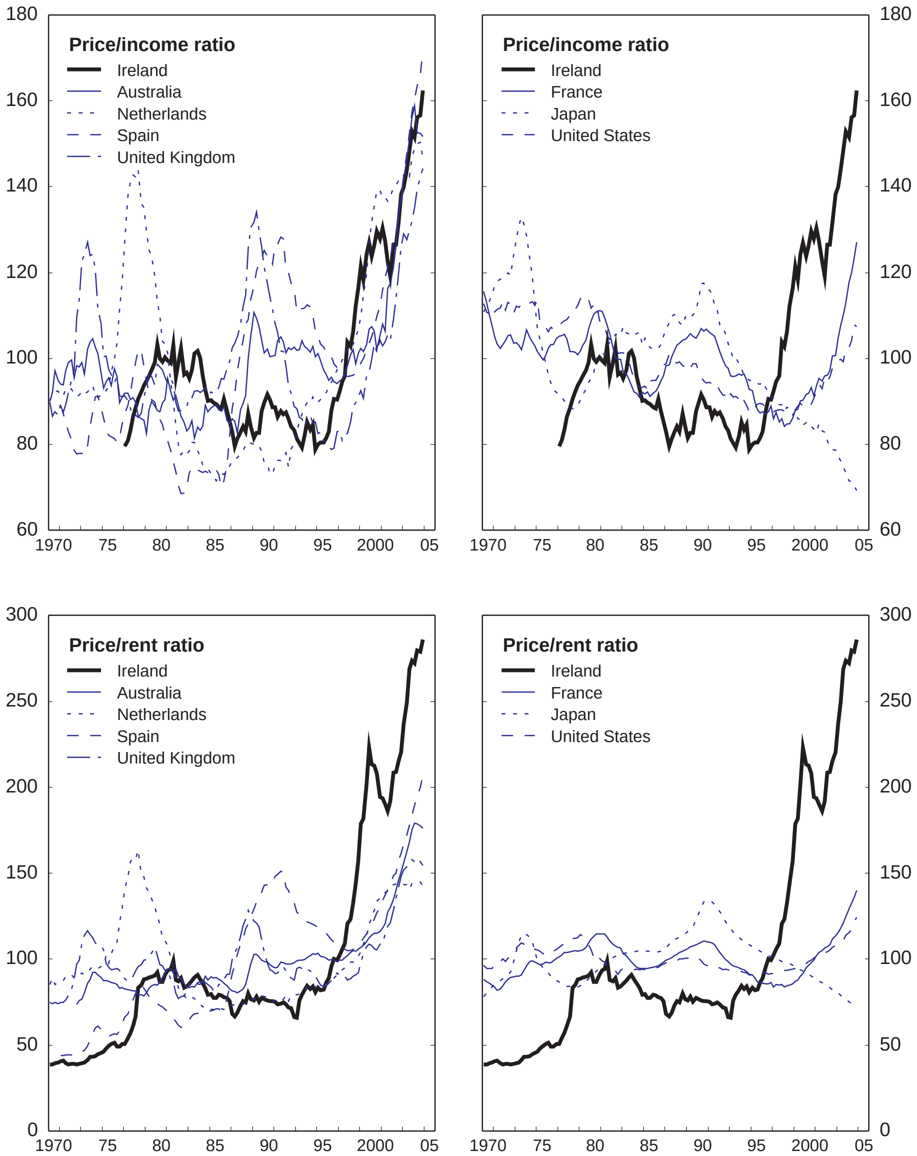
Housing costs including household maintenance, index Belgium = 100



Source: Eurostat.

Figure 9. House prices are generally high relative to rents and income

Sample average = 100



Source: OECD (2005), *OECD Economic Outlook*, No. 78.

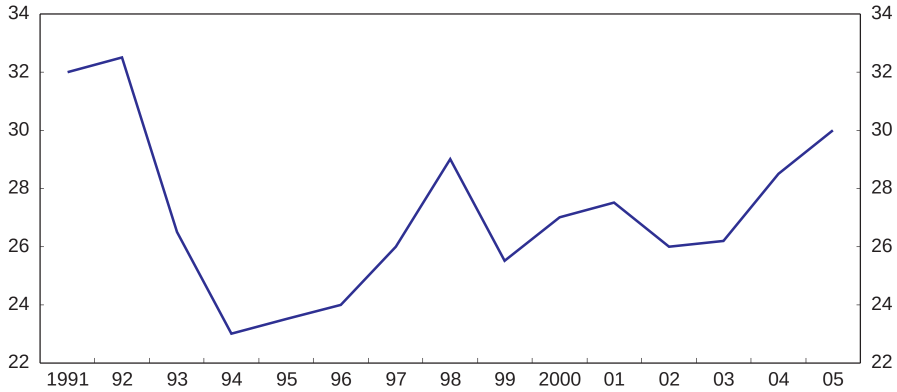
in these two ratios far outstrips the cycles that have been seen in other countries before the most recent global housing boom (Figure 9), although the increase in the price-to-income ratio is in line with some other countries that have also enjoyed booming house prices in the last five years.

The forward-looking present value approach

In theory, permanently lower interest rates should lead to permanently higher price-to-rent and price-to-income ratios. Therefore, *some* increase in these ratios, as identified in the previous paragraph, is justified by the decline in Irish real interest rates. Whether the run-up is *fully* justified can be assessed using the forward-looking present value approach. It determines the fundamental house price as the present

Figure 10. Mortgage repayment burden for a first-time buyer

Mortgage repayments as a proportion of disposable income



Source: Irish Central Bank.

discounted value of expected future rental income from the property and has the advantage over econometric models that it relates the fundamental price to expectations of the future rather than comparing it to past developments. Real incomes have now converged to the euro area average but house prices have substantially overshot the European average. This would imply that people expect growth in Irish incomes to remain above the euro area average for some time to come, and this is probably a fair assumption. If the annual rental income on private housing remains at € 13 000 and assuming a discount rate of 2%, the present value model would give a fundamental house price that is close to current levels. That is, this model concludes that current prices can be justified so long as interest rates remain at their current low level. However, assuming a more reasonable discount rate that reflects long-term expectations of interest rates of around 4%, the present value model yields a 20% overvaluation.

Affordability

The concept of housing "affordability" is popular in public discussions and with the real estate industry, perhaps because of its simplicity. While it is not particularly useful for assessing house price over-valuation, it is a useful measure of cash flow pressures. In 2005, the average mortgage repayment burden for a first time buyer was estimated to be 30% of disposable income (Central Bank, 2005), which is higher than in 1994/95, but is actually slightly lower than it was in 1991, when interest rates were much higher (Figure 10). Thus, the repayment burden is not out of line with past levels – provided, of course, that interest rates remain low.

Other evidence

The effects of increased housing wealth and equity withdrawal on household saving have never been strong in Ireland. The savings rate has been fluctuating around 9% throughout the housing boom. However, this does not imply that no housing equity is released, but rather that it may be recycled back into the housing market. This shows up especially in the buy-to-let market and in the rapid growth in the number of secondary or otherwise mostly vacant homes. This suggests that demand is driven, at least in part, by expectations of capital gains, which may confirm the impression of over valuation emerging from some of the quantitative indicators.

The buy-to-let market is small but has been growing fast.[3] New buy-to-let mortgages constituted 20% of all mortgage transactions in 2004 while 30% of second-hand dwellings sold during the first half of 2004 were previously held as investment properties. The buy-to-let market is dominated by small, mostly inexperienced investors, whose primary objective is to provide for retirement. With property investors taking such an active part in the market, the question is to what extent they have driven up house prices. Attracted by the substantial capital gains and small carrying costs, many investors have entered the buy-to-let market, possibly displacing first time buyers and contributing significantly to housing demand and house prices. The main concern – and another indication of overshooting prices – is the growing divergence between property prices and rental income. Indeed, rents actually fell from 2002 to early 2005. The position of those in the buy-to-let segment of the market will continue to be sustainable only if interest rates stay low. However, if mortgage rates were to rise many of these investment positions would be loss making.

Demand for second homes appears to be another important factor in the housing market. Although housing supply has risen tremendously in recent years, a surprisingly large proportion of it appears to be satisfying demand for second-home properties (in 2005, around 15% of homeowners aged 35-54 owned a second home). As in the case of the buy-to-let market, some properties may have been acquired with the expectation that house prices would continue to grow at a fast pace for the indefinite future. More generally, an important element of the boom over the last decade has been the growth in the number of dwellings that are vacant, for whatever reasons, for most of the year. Fitz Gerald *et al.* (2003) calculated that the number of vacant dwellings in Ireland had increased by 80 000 from 2000 to 2003, which is equivalent to half the houses constructed over that period. On the basis of modelling work in that paper it was estimated that this additional demand would have added between 15 and 20% to house prices over the same period, which roughly corresponds to the overvaluation estimated in the econometric model above.

Key policy issues

Risks to financial stability

An over-valued housing market may have implications for financial stability, but that depends on many factors. The first point to note is that an overvaluation does not imply that prices will drop, at least if the degree of overvaluation is moderate. The housing market is unlike other asset markets in that house price dynamics are not symmetric. Prices rise quickly during booms, but in a market slump most people prefer to take their house off the market rather than sell at a loss. Hence, a *small* fall in prices followed by several years of a flat market is more likely than a sharp drop in house values. Put another way, the price level may remain fairly high as the market waits for the underlying fundamentals to catch up. Another factor working in favour of this benign scenario is that, in the past, house price slumps have usually been triggered by a hike in interest rates, and while interest rates in the euro area are back on an upward path, the increase is likely to be relatively mild – a hike in rates has usually been the trigger for price slumps in the past. But even if they are not overvalued, concerns about stability still arise. If the fundamental drivers were themselves subject to severe negative shocks – such as a slowdown in the expected growth rate of disposable income – then house prices could still fall substantially. This would be particularly difficult for households that are highly leveraged in the buy-to-let and secondary home markets. The sensitivity of these markets to changes in financial conditions may be illustrated by the hit to confidence and the subsequent halt in real house price growth in 2001-02 when the budget announced an increase in the stamp duty and the introduction of an anti-speculative property tax (Box 1). The potential magnitude of the problem is difficult to gauge. Average debt levels are high and are growing rapidly (Table 1), but there is little up-to-date information on how this is distributed across households. The current level of rents is not adequate to cover debt service costs for new or very recent investors (*i.e.* those with a loan-to-value ratio of at least 80%), so their financial position will be squeezed if prices do not rise as fast as they had hoped. Even if house prices level off, there is a potential macroeconomic and financial stability issue that could arise from decline in residential construction. As noted in Chapter 1, the rate of house building will need to fall to some extent to return to its sustainable long-run level. International experience shows that this process is seldom smooth: when the investment rate turns down, it usually falls sharply (Box 3).

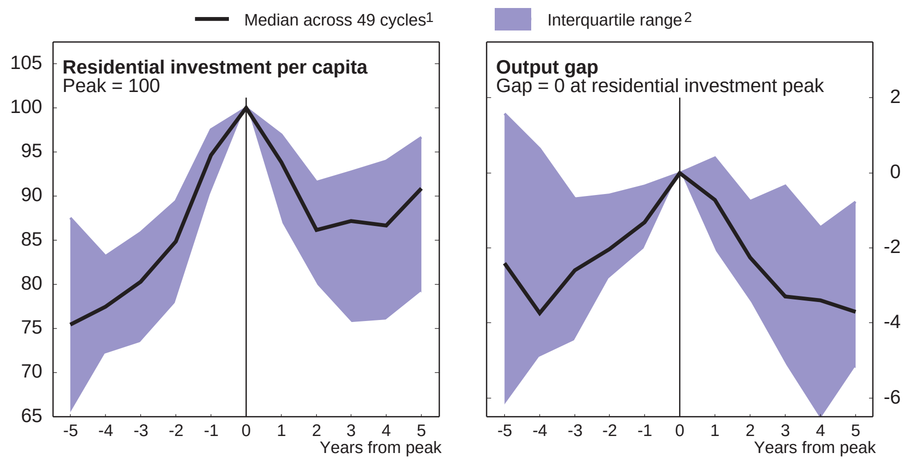
Box 3. Has residential construction ever had a soft landing?

Residential investment is characterised by a pronounced boom-bust cycle. This box looks at how often a construction boom has been followed not by a slump but by a soft landing.

Between 1960 and 2004, 49 residential construction booms have occurred in 23 countries for which data is available. A boom is defined (rather generously) as a rise in the level of real per capita residential investment of at least 15% over a five-year period. In order to avoid identifying false peaks and data blips, a peak is defined as the highest point in a window of the preceding four years and the subsequent three years. By construction, the latest peak that can be identified is 2002; the analysis therefore omits the housing booms that are currently underway. In the cycles that have been identified, the average increase in real per capita residential investment from trough to peak is around 40%. The largest occurred in Korea from 1973 to 1978 (where investment rose by 160%). The trough-to-peak increase has exceeded 50% in 16 cases.

The downturn that follows is usually rapid. On average in the first year after the peak, 40% of the increase during the trough-to-peak upswing is reversed, with another 40% lost in the second year (Figure 11). Investment stabilises at that level for two years, before beginning to recover about five years after the peak.

Figure 11. Has there ever been a soft landing?



1. In each cycle, real per capita residential investment is scaled so that the peak equals 100.
2. The shaded area shows the middle two quartiles (*i.e.* half the countries fall in this range).

Source: OECD (2005), Economic Outlook 78 database.

How common are soft landings? If a soft landing is defined as a relatively small reduction in the investment rate, they are not especially common. There have been only four cases where the decline in per capita residential investment has been smaller than one-third of the increase that occurred during the boom years (these are the Netherlands after 1978, Belgium after 1990, the United Kingdom after 1998 and Finland after 2000). Soft landings are more common if they are defined as *gradual* declines, *i.e.* where it takes at least three years to hit the trough. There have been around 20 examples of these. But all of these were comparatively deep declines. If a soft landing is defined as something that is *both mild and gradual*, there has not been a single case out of the 49 boom-bust cycles.

It is also revealing to look at the behaviour of monetary policy before and after the construction peaks. Of the 34 booms for which there is also data on short-term interest rates, monetary policy tightened before the investment peak in only a little over half of all cases. Thus, there appear to be factors other than a tightening of monetary policy that have been responsible for many of the downturns.

Stress testing by the central bank suggests that the banking system has adequate capacity to absorb a modest fall in residential construction and house prices. However, it is more exposed to a negative shock that reduces residential and commercial property prices simultaneously as more than half of the banking sector's loan book relates to property. Hence, it would be worthwhile for banks to err on the side of caution. Loan provisions are currently in line with international norms, despite Ireland's financial risks possibly being higher than in other countries.[4]

Longer-term economic efficiency

Aside from the question of whether house prices are currently overvalued, there are also issues of longer-term welfare related to the housing market. Given the high price level, the share of the average household budget that is spent on housing is high by international standards. This suggests there may be over-investment in housing and a corresponding under-investment in more productive assets.

The scarcity of accommodation in Ireland is partly a matter of misallocation of resources. To the extent that the increased stock of dwellings is absorbed as secondary or vacant dwellings, there are fewer dwellings available to meet the rise in the number of households driven by the changing age structure of the population. This has also put pressure on the resources of the building industry. Moreover, as noted by Fitz Gerald (2005) the high demand for secondary homes makes it more expensive for individuals to live and run businesses in the regions. The provision of the necessary infrastructure for new dwellings, such as sewerage and water connections, is very expensive, especially in urban areas. Where such dwellings are held vacant for investment purposes,[5] there is not an occupier to generate tax revenues to help defray the costs. Moreover, the government's social housing policy may be putting undue pressure on property prices (Box 4).

Box 4. Housing support may not be provided in the most cost-effective way

The government has substantially increased expenditure on housing support for people on low incomes. In 2004, public social expenditure on housing was more than 1½ per cent of national income – around four times the OECD average. It is unclear whether this money is well spent. There are around 15 different schemes but the government appears to have a strong preference for encouraging home ownership rather than providing rent assistance (Fahey, 2004). In 2004, only 16% of total expenditure went towards rent subsidies (housing benefits); approximately two-thirds went to capital expenditure, especially the construction and maintenance of local authority housing. Local authorities rent out 107 000 units at an average rent of just € 32 per week, so it is no surprise that there is a long waiting list for such housing. Expenditure on social and affordable housing schemes in 2004 amounted to € 1.88 billion and benefited 12 145 households. This subsidy is therefore equivalent to € 155 000 per household. Instead of building new houses for these families, that sum could cover all their rent for 10 to 15 years depending on the type and location of the rental accommodation. In its latest attempt to encourage home ownership, the government announced in 2005 that a further 10 000 houses would be built under its Affordable Housing scheme. People who would otherwise have to spend more than 35% of their net disposable income on a mortgage can apply to buy one of 10 000 new houses at up to a third off market value. The scheme is income tested, and is available to households earning up to around 130% of the average wage. This is in addition to the tenant purchase scheme under which social housing tenants can buy their properties at a considerable discount.

Policy needs to shift to a more tenure-neutral stance. The private rental sector, which currently is small by European standards, could expand if the government shifted more resources towards rent assistance instead of constructing houses and selling them or renting them and controlling the system through queues. Constructing houses and selling them at a low price seems especially ineffective as government assistance only takes into account a household's current, but not permanent income. It has aspects of a lottery, and its irreversibility makes it impossible to adapt to changes in situation or to households' often transitory needs. It is also a high-cost measure, so that less is available for lower cost, but more effective measures. Subsidising low-rent housing, while not suffering from irreversibility to the same extent, still often does not cater to the poorest households as it can be difficult to dislodge renters whose incomes have risen above the threshold for being placed in a low-rent flat. In addition, the owners of social housing parks usually have little incentive to maintain the property. Providing assistance by a housing benefit or housing vouchers would be entirely tenure neutral if households were free to use their means-tested benefits to cover rent or a mortgage. Means-tested housing benefits necessarily increase marginal effective tax rates on low-income earners but Ireland has relatively low marginal rates (at least on first earners) and therefore has more scope than most countries to deliver its housing policy through the income support system and let households make their own choices about whether to own or rent from the private or social sectors.

Furthermore, the level of house prices could reduce the growth potential of the economy by discouraging potential migrants, shifting the balance of labour market growth from employment to wages, with a consequent deterioration in competitiveness. Rises in house prices lead to unambiguous welfare gains for current home owners while immigrants, first time buyers and those with lower labour market skills miss out.

Tax policy issues

Some landowners are reaping large capital gains as a result of the major investment in infrastructure by the state and the rezoning of land for development. It would be appropriate for part of this windfall to be siphoned off by taxation to partly fund the infrastructure investment that creates the gain in the first place. The higher development levies that have been implemented go some way in this direction but they do not affect existing home owners. In contrast, the state is intervening in a number of different ways to encourage demand for housing, thereby pushing up the price. The tax relief on mortgage payments and the under-pricing of infrastructure encourage higher demand and higher prices, especially for land. Restrictive zoning, while popular with existing suburban residents, fuels an artificial shortage and encourages urban sprawl. Hence there is a strong argument for a property tax. But this has so far proved unacceptable to the public. As a softer alternative, some have advocated a property tax on vacant or second dwellings only (Fitz Gerald, 2005). This would help defray infrastructure costs, reduce demand and therefore reduce price pressures, thereby enhancing the productive potential of the wider economy. A very important side effect is that it would reduce the share of this potentially most volatile element in the housing stock.

Box 5. Summary of recommendations

- Phase out the strong bias towards housing that is embedded in the tax system. For example, mortgage interest should not be tax deductible unless a tax on imputed rental incomes or a broader capital gains tax is introduced.
- Introduce a property tax in order to fund local infrastructure and services, and as a way of redistributing some of the windfall gains that accrue to people living close to new roads and public transport links.
- Encourage banks to be sufficiently prudent in their lending and loan-loss provisioning practices.
- Social housing policy should become more tenure-neutral by scaling back house building and providing more by way of income support and/or housing vouchers.

Notes

1. For Ireland, the user cost is computed by Barham (2004) following the method of Poterba (1984).

2. The figures in the right-hand panel come from the Economist Intelligence Unit and are based on a 100 m² apartment close to the city centre. They are highly correlated with the Union Bank of Switzerland's cost of living comparison in different cities (correlation coefficient of 0.78).

3. In 2004, around 8% of the housing stock was for private rental.

4. Loan loss provisions fell from 1.4% of loans in 2000 to 0.7% in the second quarter of 2005 (Central Bank, 2005). This level is in line with other European countries (Hoeller *et al.*, 2004).

5. There was a strange tax loophole until 2002 which meant that it could be worthwhile for a landlord who owned multiple properties to buy an additional property and keep it vacant.

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HOUSES OF THE OIREACHTAS

Volume 1 **Number 7**

AN COMHCHOISTE FIOSRÚCHÁIN I DTAOBH NA GÉARCHÉIME BAINCÉIREACHTA

JOINT COMMITTEE OF INQUIRY INTO THE BANKING CRISIS

Dé Céadaoin, 11 Feabhra 2015

Wednesday, 11 February 2015

The Committee met at 9.30 a.m.

MEMBERS PRESENT:

Deputy Pearse Doherty,	Senator Sean D. Barrett,
Deputy Joe Higgins,	Senator Michael D’Arcy,
Deputy Michael McGrath,	Senator Marc MacSharry,
Deputy Eoghan Murphy,	Senator Susan O’Keeffe.
Deputy Kieran O’Donnell,	
Deputy John Paul Phelan,	

DEPUTY CIARÁN LYNCH IN THE CHAIR.

Professor John FitzGerald

Chairman: The committee is in public session. Today we will hear from Professor John FitzGerald on issues relating to the international, EU and domestic policy context for the banking crisis in Ireland, and in particular the ESRI's medium-term reviews in the years prior to Ireland's banking crisis. I welcome everyone to the eighth hearing of the Joint Committee of Inquiry into the Banking Crisis. Professor FitzGerald is very welcome to the inquiry.

Professor John FitzGerald: Thank you.

Chairman: Professor John FitzGerald has been a research affiliate at the ESRI since November 2014. Prior to that he was a research professor at the ESRI and programme co-ordinator of the macro-economics research area. He is president of the Association d'Instituts Européens de Conjoncture Économique and a former president of the Irish Economic Association. He is presently a member of the commission of the Central Bank of Ireland and of the independent expert panel established in 2014 by the Department of Communications, Energy and Natural Resources.

Professor FitzGerald has published in a number of different fields. In collaboration with his colleagues in the ESRI, he helped develop the ESRI's macro-economic modelling programme. He was a joint author of the report for the Department of Finance on the economic implications for Ireland of the EMU which was published in July 1996. This report was central to the debate on Ireland's membership of the EMU.

He is a joint author of the ESRI's medium-term review which provides a detailed analysis of Ireland's economic prospects over the next decade. In 2011 John FitzGerald was admitted as a member of the Royal Irish Academy in recognition of his work on the behavioural characteristics of the Irish economy.

I advise that by virtue of section 17(2)(*l*) of Defamation Act 2009, the witness is protected by absolute privilege in respect of his evidence to the committee. If he is directed by the Chairman to cease giving evidence on a particular matter and continues to do so, he is entitled thereafter only to a qualified privilege in respect of his evidence. The witness is directed that only evidence connected with the subject matter of these proceedings is to be given and, as he has been informed previously, the committee is asking him to refrain from discussing named individuals in this phase of the inquiry. I remind members of the long-standing ruling of the Chair to the effect that they should not comment on, criticise or make charges against a person outside the House or an official by name or in such a way as to make him or her identifiable.

I invite Professor FitzGerald to make his opening statement.

Professor John FitzGerald: I thank the Chairman and thank him for the invitation to appear.

I should say at the beginning that I speak for myself and I do not speak for the ESRI. I will attempt to respond to the questions, which I was asked, on a range of economic issues.

Over the period 2001-07, in a wide range of publications, together with my colleagues, we repeatedly warned about the dangers posed for the Irish economy by the growth of a property market bubble and of the need to use fiscal policy to defuse the situation. If the advice on fiscal policy had been followed, Ireland would probably have escaped much of the damage that was suffered over the recent crisis. However, we did not draw the connection between the growth of a property market bubble and the risks to the financial system. In 2008 in our medium-term review, we failed to foresee the impending financial collapse. The review had a short shelf life because six weeks later we published the quarterly economic commentary which carried headlines that Ireland was in recession. I am afraid its shelf life was short.

I was asked questions about the economic recovery of the 1990s. Having spent the 1980s dealing with a major budgetary crisis, the economy entered a period of rapid growth in the 1990s. The ground had been prepared by a very substantial improvement in competitiveness and the restoration of order to the public finances in the 1980s.

There were a number of underlying strategic factors in the Irish recovery. These included the completion of the EU Single Market which was particularly important for us at the end of 1992. In addition, there was the effect of investment in education, because Ireland had lagged behind the rest of northern European for a long period. Finally, the rising participation of women in the economy was important. These factors helped to produce a sustained rapid period of growth in the 1990s.

Due to the fact that growth was fuelled from outside of Ireland, it resulted in a substantial movement into a current account surplus of the balance of payments. That meant that savings were enough to fund investment. We did not need a capital inflow to the banking system to fund the very rapid growth because we were living within our means.

A significant part of the growth of the 1990s represented a catch up on the rest of the EU 15. There is an interesting article by Cormac Ó Gráda which was published in the ESRI's quarterly economic commentary which brings this matter out. The interesting thing about Ireland was that bad policy, over a very long period, managed to keep us down. Then we had a recovery in the 1990s which acted as a catch up to probably where we should have been otherwise.

By the end of the 1990s, and into the first few years of the 2000s, the catch up phase was completed and the rate of productivity growth slowed rapidly. While exports continued to grow, domestic demand began to rise quite fast. People reacted to their higher living standards by spending more on consumption and, in particular, investment in housing. This rise in domestic demand was further fuelled by stimulatory fiscal policy which going back to the medium-term review of 1999-2001, and so on, we felt was unwise and a fueling of an already very rapidly growing economy. Rising expectations saw a gradual disimprovement in competitiveness due to wage inflation which adversely affected exports. The current account of the balance turned negative. I expressed serious concerns about the nature of fiscal policy, in particular in 2001, but it was probably only in 2003 that growth really began to outstrip the potential of the economy, giving cause for real concern. The bursting of the dotcom bubble in 2002 took the steam out of the economy, which we were worried about in 2001, and that postponed the turning point.

I was asked to say something on the external policy environment. With the advent of monetary union in 1999, the ECB took over control of monetary policy so that interest rates were not set to meet the needs of individual economies. They were set as they are today to meet the needs not of Germany but of the EU economy as a whole. Monetary union also facilitated the free movement of capital, as anticipated. It reduced the risk premium, which is the cost of capital. In the 20 years between 1979 and 1999, Ireland paid 2% more on average than Germany, controlling for everything else. There was a risk premium which meant investment was more expensive. We were less competitive than Germany. That risk premium disappeared with monetary union. Prior to monetary union, Ireland and Spain had probably under-invested in housing as we had a higher cost of capital than in countries like Germany or France. Given the demographic profile, we needed to invest in housing. In permitting a more rapid adjustment to the housing stock, the lower cost of capital was beneficial. However, it was the failure to appropriately control this surge in investment which eventually proved fatal.

Monetary union had its benefits, but it required governments to act differently. In our case and in the case of Spain, governments did not act differently. When the property boom got out of control in the period 2003 to 2007, the intensity of the investment went well beyond domestic savings and the counterpart to the deficit was the inflow of funds through the banking system. The demand for credit to fund investment ran well ahead of the ability of the banks to meet from their own domestic funds. However, it proved easy and cheap to borrow additional funds abroad. In the period before monetary union, a constraint on such expansion might have been the exchange risk involved in such borrowing but the experience of EU countries outside monetary union shows that a change in the world economy had taken place. This was partly due to US policy and meant that cheap money was available not just because of monetary union. Estonia and Latvia were not members of the eurozone, but they suffered exactly the same experience of a massive property bubble fuelled by very large investment through the banking system of very cheap money. One should not blame monetary union as it was a worldwide phenomenon of cheap money which governments and central banks failed to manage appropriately.

The turning point was 2003, but one can argue about it. The current account of the balance of payments was in deficit that year, though the size was small, but wages had been rising rapidly for a number of years and the loss of competitiveness was beginning to take a toll, notwithstanding that it was not yet that serious. House prices in 2003 returned to growth at more than 10% a year and the demand for credit was outstripping the ability of the banks to fund it. One began to see the banks borrowing abroad in the inter-bank market to fund the expansion of credit. The demand for housing, however, had a real basis in terms of the rising population. House completions at nearly 70,000 were running ahead of the actual increase in population and there was no sign of the rate of increase in house prices slowing. An important factor driving that was what I call the “user cost”. People expected house prices to rise in future which made buying a house much better than renting because rents would go up. That proved self-fulfilling and produced a bubble effect. Over the period to 2007, the current account deficit ballooned reflecting the fact that domestic savings were not enough to fund the investment boom. We had to borrow from abroad, which resulted in increasing vulnerability for the banking system and a rapid rise in household indebtedness.

It is impossible to identify when the bubble became irreversible. The last chance to stop it without disaster was probably in 2006. By the end of that year and moving into 2007, house prices were far above their equilibrium level and collapse became inevitable. I have provided the committee with a detailed appendix which I will not go through here. It shows that the dangers were apparent, even if disaster was not certain. One further factor which aggravated the cost of the collapse was the fact that the building and construction sector was like a tumour which grew and grew, squeezing the rest of the economy. Fortunately, it turns out not to have been cancerous and we are getting over it. However, real jobs were squeezed out in the rest of the economy. This contrasts with the situation in the UK, which also had a property bubble. However, they did not allow any building so that when prices collapsed, there was not a collapse in a large part of the economy. The expansion of the building sector in Ireland meant that it had to bid resources away from the rest of the economy. This was done through inflation which made the rest of the economy uncompetitive. This killed off a significant number of firms and jobs in the exporting sector. These jobs did not seem important at the time and nobody noticed they were going in the absence of news headlines, but they have proved crucial. We really need those jobs today.

I turn finally to the policy response. The dangers the economy faced as a result of the over-inflation of house prices, the build-up of debt and the loss of competitiveness in the economy were foreseeable and foreseen. The build-up of the bubble could have been prevented by appropriate fiscal policy or by appropriate prudential action by the Central Bank and the regulator, or both. Either one of these policy instruments, if appropriately deployed, could probably on its own have prevented disaster. Both together would have prevented disaster. On fiscal policy, I note that from 2001 onwards in many publications, I and my colleagues pointed to the need to tighten fiscal policy. Instead, in an economy that was growing strongly and well above potential, fiscal policy pumped money into the economy in six out of eight budgets. There is a graph which shows this. When the economy was growing rapidly, successive Governments pumped money into it, which greatly aggravated the situation. If instead the Government had run a deflationary fiscal policy, as we recommended repeatedly, and built up a substantial surplus, it would have taken the steam out of the housing market and reduced pressure on the labour market. The case of Finland is instructive. Having experienced the same disaster we did only 20 years earlier, it ran up a current government surplus of 5% to prevent a repetition.

In addition to operating a much tighter fiscal policy in the 2001-07 period, I recommended using specific fiscal instruments to take the heat out of the building and construction sector. We recommended getting rid of all building incentives and, possibly, taxing mortgage interest payments. The UK Treasury visited us and published a paper in 2003 which said that if the UK joined monetary union it would need to use fiscal instruments to manage the housing market. The Treasury recommended using stamp duty, but the problem with that is it would lead to higher household debt. My feeling was that taxing mortgage interest payments would discourage people from taking on debt. As people would end up with lower debt, it would be a better instrument. Either way, one could have used fiscal instruments to take the heat out of construction. A further result would have been a smaller balance sheet in the banking sector. If the building sector had not been allowed to grow and fewer houses had been bought at lower prices, the banking sector would not have been vulnerable.

I will not go into banking regulation and macro-prudential policy in detail. It was the other instrument which could have been used. There were a range of ways the Central Bank and the regulator could have stopped the growth in credit, as demonstrated by research from within the Central Bank itself by Kieran McQuinn and Gerard O'Reilly. They wrote a number of papers on how credit growth is important in fuelling house prices. If the credit channel had been choked off in 2003 to 2007 by the regulator, it would have halted the rise in house prices or, at least, achieved an appropriate moderation. Policy instruments were available.

By 2007, it was probably too late to prevent a major crisis from occurring in 2008. However, if urgent action had been taken in the form of a tightening of fiscal policy or regulatory action, it would have reduced the subsequent damage. It would have reduced the indebtedness of the household sector by stopping the boom earlier. If people who bought in 2007 had not bought, they would not be in difficulties today. The bloated balance sheets of the banks would have been smaller. However, if policy makers ever considered such action, which I do not think they did, they might have decided that bursting the bubble deliberately in 2007 or early 2008, with serious consequences, was much less attractive than hoping for redemption by delaying action. It became politically difficult even at the best of times to take action once things had gone that far. If any action had been taken in 2007, it would probably have left a smaller problem to be dealt with.

Chairman: Before I turn to our lead questioners, Deputy Pearse Doherty and Senator Michael D'Arcy, I will do some scene setting with Professor FitzGerald to provide some clarity on the role of the ESRI and its relationship with the Department of Finance. The ESRI is often described as the Government think tank. Is this an accurate description? Will Professor FitzGerald describe the ESRI's functions, how it is funded and the nature of its advisory role to the Government?

Professor John FitzGerald: The ESRI was founded in 1960 to provide independent advice to the Government. Professor Joe Lee in his *Ireland, 1912-1985: Politics and Society*, commented on the fact that universities were not producing useful research at the time. It was an initiative led by Dr. Ken Whitaker, the then Secretary of the Department of Finance. To guarantee its independence, he sought funding for it from the Ford Foundation. He told me that he discovered that the person responsible for funding in the Ford Foundation served mass in a church in New York. He went to mass and nobbled him after it to get the money for the ESRI. For the first four years, it was totally independent of the Government. That was the intention of both the Government and the Secretary of the Department of Finance.

The ESRI is legally a charity. The Department of Finance took over giving it 100% funding when the Ford Foundation money ran out in the middle 1960s. The ESRI was about 80% funded by a direct grant from the Department of Finance until the late 1980s. Then there were pretty dramatic cutbacks, as we know, and the ESRI chose to survive by looking for research contracts from the EU, other Departments and so on. Today, approximately 30% of its funding comes from grant-in-aid from the Department of Public Expenditure and Reform with the other 70% coming from a range of sources such as public research funding from the EU, SFI, Science Foundation Ireland, Departments and public bodies, with a limited amount from the private sector. The ESRI insists on publishing everything it does without censorship. The private sector is not generally prepared to fund public good research.

The ESRI is governed by a director who is responsible to a council. The council is not appointed by the Government but co-opts its membership. Until the late years of the last decade, the Secretary General of the Department of Finance was always a member of the council. It is now an assistant secretary from the Department of Public Expenditure and Reform. The Central Bank Governor has generally been a member. There is a range of people broadly representative of civil society. The council is not appointed by the Government, a provision which is there to ensure its independence.

The Department of Finance has been party to these ground rules. Generally, it has been good to deal with. It understands we kick them and they grin and bear it. There are times when things have been less happy, however.

Chairman: Members of the committee will raise questions about the medium-term reviews from the ESRI. What is the purpose of these reviews? What was Professor FitzGerald's role in producing them?

Professor John FitzGerald: The first one was published in 1986 but I was not involved in that. Since 1987, I have been involved in these medium-term reviews. Initially with my colleague, John Bradley, through the 1990s we were jointly responsible for it. Since 1989, I have been the lead author but with other colleagues. It has been published every two or three years. It uses a range of tools to understand how the economy behaves and to look in a longer term context over several years at what are the strategic issues and how policy can produce a better outcome.

Reflecting the fact we do not know what the future is going to bring, we always publish a range of scenarios. This always poses problems for the media. We tried producing two scenarios and it asked if it was the higher or the lower. Then we tried producing three scenarios and it asked is it the middle one. The rest of the world has difficulty dealing with uncertainty just as we do. Since 1987, we have developed the Harmonised Econometric Research for Modelling Economic Systems, HERMES, model and have a range of other tools we use in undertaking the work.

Chairman: What is relationship between the ESRI and the Department of Finance in the publication of the medium-term reviews? Does the ESRI do this in co-operation with the Department? Is it through a request from the Department?

Professor John FitzGerald: It is totally independent and funded out of the grant-in-aid. It is quite an expensive process, costing approximately €250,000 or more in terms of resources. As it is funded out of the grant-in-aid, it means it would be impossible for the institute to publish one of these reviews every year. We were offered funding by a large bank in the late 1990s to sponsor it but we certainly rejected that. The review is independent of the Department of Finance.

Part of the quality control process in the ESRI is that it is reviewed by anonymous referees not involved in the institute. On policy relevant research, we tend to send it to interested bodies which could spot problems or come up with suggestions. We have always sent it to the Department of Finance and we always get comments back from it.

Chairman: Is it the ESRI which decides the final publication of the review?

Professor John FitzGerald: The Department of Finance has no role in that. We decide what we are going to do. Over the years, the Department has always had problems with it. The Department's comments come in two kinds. There are the really useful technical comments. Over 30 years, there are people in the Department who discover inconsistencies. There are very few other people outside who can do so and it is very useful. Then there are political comments. We know and they know they are political comments. We ignore them but they have got to say it. Over most of the past 30 years, the Department knew the ground rules and that we would ignore them. In the last decade, the Department became a little grumpier when we did not accept its political views. The ground rules are there in that it can say what it likes and we can say what we like.

Chairman: In his opening statement, Professor FitzGerald stated:

> With all ESRI reports, the conclusions in each report were the personal responsibility of the authors. They did not represent the views of the ESRI. The ESRI with all its publications operates a quality control process where the publications were vetted in advance by independent reviewers to ensure they met an appropriate academic standard.

Does this apply to the ESRI's economic quarterly commentaries and medium-term reviews? If that is the case, will he explain why these outputs did not represent the collective views of the organisation?

Professor John FitzGerald: Going back to its foundation, like a university, the institute did not want to be responsible for the views of its authors. There were various rows in the past about this, particularly in the 1970s. If the research is of academic quality and does not libel anybody, it will be published. It is like a university. The director or the council may not like what has been said in a report but it vindicates the right of the researcher to publish the results of his or her research which has been peer-reviewed and is of quality, even if they do not necessarily agree with it. For example, if a professor in Trinity College Dublin says something, the provost is not expected to answer for that. In the public mind, people believe the ESRI thinks. The ESRI does not think. It is its researchers that think. The ESRI corporately does not take responsibility but it does take responsibility for the quality of the research and that it stands up academically.

Deputy Pearse Doherty: In his opening statement, Professor FitzGerald stated he and his ESRI colleagues did not draw the connection between the growth of a property market bubble and the risks to the financial system and in the 2008 medium-term review, it failed to foresee the impending financial collapse. Given the ESRI's level of expertise in the Irish economy, why does he believe the financial risks due to the commercial and residential property bubble were not factored into its forecasts?

Professor John FitzGerald: First, the ESRI does not like to campaign. Instead, in both quarterly economic commentaries and medium-term reviews, we prefer to rely on research. We are uncomfortable with moving too far away from research. We had not done research on the financial sector since the late 1990s when Patrick Honohan left in 1998. Our area of expertise, one in which we had done a lot of research and are the experts, is fiscal policy. We concentrated on that channel. As I indicated earlier, if that channel had been operated properly, we would not have got into the mess.

We were conscious there were problems, however. I wrote to the Central Bank in February 2006 about an issue. I contacted it again in March or April 2007 about my concerns. If one looks at the 2007 April spring quarterly commentary, we did mention the financial risks. In addition, we mentioned this in papers back to 2004 in the Dublin Economics Workshop. While we were conscious they were there, because we had not done research, we did not go into detail on that. Looking back on it, had I even looked at the data on the balance sheet of the banking system, I would have known there was a major problem. I would not have needed a lot of research to conclude it was not just fiscal policy. I feel that I made a serious mistake in not looking at the data on that. I suppose a lot of people relied on the fact that the Central Bank had the biggest number of economists doing research. As they were doing research on that area, were we to go out seeking funding for such research, the response would have been the Central Bank was doing it. The lesson for the future is that there is a need for two people or bodies to undertake research on any given area. However, what happened is a cause of regret. It is not because we were told not to, rather it is why I did not look at the data, as it would have stood out. Even though we had not done research, I think I would have said something on it.

Deputy Pearse Doherty: In respect of research carried out and published by others in newspaper articles - Morgan Kelly is one who springs to mind for example - was such research simply ignored by the ESRI in its forecasts?

Professor John FitzGerald: No. I think the first discussion of what Morgan Kelly was producing was in September 2007. We were conscious of the fact there was a problem but made a call that Ireland probably would escape it. We were totally wrong. If we had known there would be a financial collapse elsewhere, then we would have known there was going to be one here. The way we operate when doing our forecasts is that we do not forecast for the rest of the world but take scenarios drawn up by the IMF, the National Institute of Economic and Social Research in London, the OECD or whatever and then plug them into the model. We plugged it in and as nobody expected a financial collapse, we therefore did not get one in Ireland. However, that is a cop-out. We should have seen the problem. As for Anglo Irish Bank, we may have discussed the problem at the quarterly editorial meeting in April of that year. One thing I learned is one does not say a bank is going to go bust or one will be sued for libel. However, that was not the reason. It was just that we concentrated on what we did well and did not open our eyes to a wider horizon. We then published in May but by June, it was clear that disaster was on the way.

Deputy Pearse Doherty: Was there a lack of expertise within the ESRI in respect of financial and banking matters?

Professor John FitzGerald: One would not have needed much expertise to know that there was a problem, were one to look at the data. However, we did not do research on the financial or banking sector. We had limited funding and on the macroeconomic side we had a long-standing specialism in fiscal policy.

Deputy Pearse Doherty: I appreciate the funding model as Professor FitzGerald has outlined earlier. However, the organisation or the authors of its reports did go on to draw firm conclusions. For example, in the 2008 medium-term review, its authors wrote:

> The fundamentals of the Irish economy are sound. Even if the immediate future may prove quite difficult, the resilience of the economy is such that, if properly managed, it is likely to return to healthy economic growth in the medium term.

That was published in May 2008. Can Professor FitzGerald explain to members what, in his view, were the fundamentals about which the ESRI was talking that were sound at that point?

Professor John FitzGerald: We were talking about the real economy that produces goods and services for export. Actually, on that, I think we were right. When the IMF came to town in late 2008 and in 2009, it said the economy was broken and would never recover. In particular, it stated that lasting damage would be done to the tradeable sector, that is, the export sector. Were one to plug in the right numbers in terms of the financial sector, the model we had of the economy actually explained what happened to the real economy and we can see the real economy is recovering now. However, what it did not see was the catastrophic damage done by the financial collapse, in which one had a dramatic fall in output. I believed then that the economy would recover from whatever happened and I think that actually is what is happening. Nevertheless, that does not excuse the fact that we did not see the financial collapse. We published an article in 2011 in which we considered how the economy's behaviour was in line with previous behaviour, if one put in the right external numbers into our way of understanding the economy. In an updated medium-term review in 2010, we published a high and low scenario for Ireland out to 2020 on the basis that the real economy was not broken and that the business sector would respond in a recovery. It actually now looks as though the outturn for the decade will be somewhere between our high and low projections from 2010.

Deputy Pearse Doherty: Let me simplify this. Does Professor FitzGerald stand by the statement of May 2008 that the fundamentals of the Irish economy were sound?

Professor John FitzGerald: No. The financial sector patently was massively unsound. The sector that produces goods and services was sound and has recovered. However, we know that the disaster has had a huge impact on the economy and consequently, not seeing the unsound nature of the financial sector was a bad mistake.

Deputy Pearse Doherty: Professor FitzGerald has told the committee the ESRI did not conduct research in areas of banking or financial institutions, yet it came to conclusions that suggested the fundamentals were sound. I assume Professor FitzGerald would suggest that a properly functioning banking system is one fundamental of the economy. Can he explain to the committee why the ESRI came to such a conclusion in May 2008, given what was happening and what was known about at that time, such as the share prices in banks, investor confidence and what the markets were saying? Why did the ESRI reach such a strong conclusion?

Professor John FitzGerald: There were two possible outcomes. One was if the world had a normal type of recession or slowdown and the other was if there was a financial collapse. The world not having a financial collapse was what all the forecasts we were using were suggesting. None of the major institutions on which we relied - we did not have expertise in that area - were suggesting a financial collapse when we put the thing to bed in March or April 2008 and we relied on that. While we did include a scenario in respect of liquidity constraint, it was much too mild. We should have seen there were two possible scenarios. However, in May, after the publication of the medium-term review, I attended a meeting of the organisation of which I now am president in Europe and what I heard there from the other economic institutes in Europe suggested things were substantially worse. There was a particular presentation by an economist from the National Institute of Economic and Social Research in London which looked at how a financial collapse in the United States could ramify to Europe and would have a much more dramatic impact. Immediately after the publication, I became aware that the rest of the world was contemplating matters being much worse and then, six weeks later, in a quarterly economic commentary, we stated we thought there was going to be a recession and that it was clear we were wrong. We took numbers from outside which proved to be massively wrong and relied on them and did not contemplate the other outcome, which unfortunately, we now know happened.

Deputy Pearse Doherty: Earlier on, Professor FitzGerald mentioned the ESRI publishes everything it does without censorship. In July 2000, *The Irish Times* reported that changes to a draft of the medium-term review were requested by an unnamed official in the Department of Finance. These were in respect of strong criticisms made of then proposed single regulatory authority. In 2003, *The Irish Times* again reported on perceived Government influence on the medium-term review of the national development plan, stating that a recommendation to the effect that spending on the national road programme be left unchanged was replaced by a recommendation that it be increased. Can Professor FitzGerald outline to the committee whether unnamed officials within the Department of Finance, for example, in respect of the 2000 report, requested changes to the medium-term review? Were such requests acceded to?

Professor John FitzGerald: I was just told about this last night and so have not checked the ESRI's records. However, I have checked my own records and refer to the period between 27 September and 2 October 1999. On behalf of the United Nations climate change commission, I was in Warsaw to examine Polish compliance with the climate change protocols. I was telephoned by the director of the institute while I was in Warsaw to say that the Department of Finance had been jumping up and down about a particular article. I discussed it with the director and it seemed to me that the Department's comments were political and should be ignored. I checked this and note that the first set of chapters of the medium-term review were finalised,

Deputy Pearse Doherty: Was this censorship by the Department of Finance?

Professor John FitzGerald: No. It was a nervous Nellie in the Department of Finance. The Department of Finance is interesting. The fact that we were suggesting raising corporation tax was not a problem for the Department. The normal people who dealt with us in the Department would view that as the normal call of the ESRI. It was somebody in the Department of Finance in a different section who did not normally deal with us and it should have been ignored.

Deputy Pearse Doherty: Were changes requested and made to the medium-term review of 2008?

Professor John FitzGerald: The Department was grumpy in its comments on that. One can get its comments under freedom of information. It was not that helpful. The Department was upset with a report we did for it in 2006 on investment priorities which said its plans for investment were way too ambitious and it should take money out of the economy. The Department was cross that we published that. There is a reference in the comments to us revisiting that where it was said to us, "Get over it; you were wrong on that". I do not have the comments in front of me-----

Deputy Pearse Doherty: If the Professor does not have them, we will not dwell on them.

Professor John FitzGerald: -----but they were unhelpful and, therefore, largely ignored. If what the Deputy is getting at is the suggestion that the Department told us what to say regarding the economy, the answer is "No". He can get the comments and he will see there is nothing about that in them. It was our mistake. What I was interested in was whether the Department was saying that what we said was being too ambitious but it did not do so.

Deputy Pearse Doherty: In March 2001, Professor FitzGerald was critical of the then-Minister for Finance, Charlie McCreevy, and the changes made to the 60% capital gains rate on zoned lands. *The Irish Times* reported Professor FitzGerald saying there was no incentive for the developers not to hoard land that should be used for residential development. He was also critical of the Minister's plan not to proceed with the 9% stamp duty on second homes and the 2% anti-speculation tax for the first three years on those homes. Can the Professor explain to the committee what the issues were and why he felt he needed to criticise the Minister so publicly in relation to this? What was the effect of those measures on zoned land and of the dropping of what was labelled at the time the "anti-speculator" tax on second homes? What type of engagement was there between the Professor and officials and the Minister in response to those criticisms?

Professor John FitzGerald: I cannot remember. I am delighted I was as critical as I was. The ESRI tends not to campaign. Instead of saying a Minister is mad, I would say, "The policy is unwise". I am surprised I was upfront in any criticism there. In terms of interaction with the Department of Finance, there would have been much closer discussions. There was a cultural change in the Department of Finance in the last decade. It became more concerned about the politics of things and less interested in the technical detail. I would have had less interaction. Also, I was getting older and having been in the Department of Finance up to 1984, I would have had lots of friends. On that, we published an article in 2001. I went back last night and looked at the 1999 medium-term review because of the issues I heard the committee was going to raise. Even then, we were critical of fiscal policy, which is what the Deputy is talking about. The fiscal policy was most unwise and it fuelled the problem. If we had a sensible fiscal policy, we would not be where we are now.

Deputy Pearse Doherty: In relation to the expertise the ESRI holds, notwithstanding that it got a number of things wrong as the Professor has acknowledged, were any officials, including the Professor, contacted by the Department or the Minister in relation to the events leading up to the guarantee, the decision itself or afterwards? Was there any consultation with the ESRI and were its views requested by anybody in that regard? If so, can Professor FitzGerald outline to the committee how that took place?

Professor John FitzGerald: There was no consultation whatsoever with us. Relations would have been frosty and the Department would not have wanted to come and talk to us about this. To my knowledge, there was no discussion prior to the guarantee. Subsequent to it, the Minister came to meet people in the institute. I have here the dates, which were 14 January and 20 March 2009. I may then have met the Minister on 5 October. I met him with David Duffy on 11 February 2010. Finally, I was at a meeting with the Taoiseach, the Governor of the Central Bank and Minister for Finance, at which many officials were present, on 16 October 2010. In the meetings with the Minister in 2009 we concentrated on issues other than the financial sector because we had not done research on that area. One area that did feature was our research on the public sector pay premium which the Minister discussed with my colleagues who were experts in that area. There was a range of issues in that the discussion was in our area of expertise, fiscal policy, how we were to get out of the mess. I specifically remember that when he raised the issue – and he was interested in our advice on the financial sector – we said he should talk to Patrick Honohan in Trinity College, he was the expert on that. That happened either at the meeting on 14 January or on 20 March 2009.

Chairman: I would like some clarification on the professor's response to Deputy Doherty. He said he wrote to the Central Bank in 2006 expressing a series of concerns. Is that right?

Professor John FitzGerald: Yes, it was addressed to the regulator.

Chairman: What were those concerns?

Professor John FitzGerald: We led a network of ten European research institutes, which did independent forecasts for the EU Commission and in January 2006 we had a preliminary meeting to draw up the forecast in Warsaw. I became aware, partly through the assistance of the Irish ambassador there that there were many Irish investors who wanted to invest a lot of money in property in Poland. My concern was that they would have leveraged, borrowed, large sums from Irish banks, gone to Poland, and, using that as equity, leveraged again. My concern in particular was that one Irish bank had a major bank in Poland and that Ireland could be exposed unduly through this form of investment so I wrote to the regulator about that.

My concern in March–April 2007 was that I had done work with banks providing them with macro-economic scenarios, stress scenarios, where things go really wrong - it is ironic that we did not heed our own advice on this – in the period 2005 to early 2007. We gave them macro-economic numbers. What they did with them after that was their own business. I was concerned that the stress tests undertaken by the Central Bank were not onerous enough. They examined a fall in house prices but did not take account of the fact that a lot of other things would happen at the same time. They were not using a model to do this. I contacted the Central Bank about my concerns in that regard in 2007.

Chairman: Did you get a satisfactory reply from the regulator to both sets of correspondence?

Professor John FitzGerald: No.

Senator Michael D'Arcy: Professor FitzGerald is very welcome. In respect of no censorship, no influence, when people make statements and use words like "treason" about documents the professor publishes is there not a certain amount of latent influence-----

Chairman: That is a leading question. The Senator may ask a question but cannot make the statement himself.

Senator Michael D'Arcy: Is there influence in the use of words such as "treason" about papers the Professor publishes? Is there a latent influence?

Professor John FitzGerald: I was furious. It may not actually have been treason. I heard only last night that this would be brought up and I have not had access to the letters involved. There have been occasions when people have contacted us and I have been very annoyed and I would certainly do the opposite. Nobody tells me what I am to do in my report. It is my responsibility. The director does not say, "You can't say that". It is for me to decide. I was furious and the director was furious. We had not come across this before. My memory is that the director said that he was telephoned by a senior official from the Department of Finance to say this was over the top and to ignore it. If people come in with their studs up it does not make one happy. It makes one more inclined to do the opposite. Points are much more likely to score and nudge one when people make reasonable arguments and one says on balance maybe they have a point. When people do that kind of thing it does not go down well, especially when one is independent and free to choose.

Senator Michael D'Arcy: Could it influence a less senior member of staff to temper his or her language or their paper?

Professor John FitzGerald: I have had occasion with joint authors when a junior member of staff has come to me saying the comments he or she has received from outside were way over the top. I have agreed and said they should be ignored. I managed a division of the institute for several years and my view was if they were good comments take them on board, if not, I said, "It is your report, you are the author, you are responsible for what it says and don't be pushed around."

Senator Michael D'Arcy: The professor makes the point that he decides what he does within the ESRI in respect of the papers he publishes. The ESRI is probably the largest economic think tank in the State. I looked for the analysis of the nation's banking sector collapse. There seems to be very little analysis by the largest economic think tank of the €100 billion collapse of the Irish banking sector. Why is there little analysis of that nature when one considers the size of the collapse in the Irish economy?

Professor John FitzGerald: If the Senator looks at our update of the medium term review in 2010 and the medium term review 2013 - this is what I was specifically responsible for – we tried to take account of what had happened in the financial sector and consider what policy measures should be put in place and where Ireland is going. Research takes time. The ESRI does quality research. That cannot be done in three months. It takes probably a year to do a research project. The Senator could look at the research coming from my former colleagues now on matters such as credit for SMEs and a whole range of papers on micro-economic data. The Central Bank has also done excellent research so that our understanding of the problems posed for this economy by the banking crisis and the failure to resolve it quickly is much better.

Senator Michael D'Arcy: Again, what I am asking is why the ESRI has not done it?

Professor John Fitzgerald: The resources to conduct a medium term review are probably €0.25 million and a number of staff would be needed for a year to work on something. It would be less for that because a new model is being developed, Cosmo, which has the best of HERMES - all these acronyms - in the Department of Finance with the co-operation of the Central Bank. I think they are working on a financial sector for that model which would make it particularly suitable. It is a major research project over a number of years and one is talking in terms of major resources. When that model is ready, which I think will be this year, I am not sure whether the financial sector would be integrated into it but that is the tool one would want to use. I would wait until an appropriate tool is ready, but research takes time if it is to be done properly.

Senator Michael D'Arcy: Last week Professor William Black was quoted as saying that the bank guarantee was an insane decision. He also said it was the worst possible decision. What is Professor FitzGerald's opinion on the bank guarantee?

Professor John Fitzgerald: The now Governor of the Central Bank gave his inaugural lecture in Trinity College in, I think, December 2007, and identified five possible responses - the best, second best, third best. At the time he said the Government chose the fourth best. It had to do something. We now know that it was the wrong decision but I did not know that the Senator wanted to take me down the bank guarantee area. It is not something on which I have done specific research. I was not consulted on it.

Senator Michael D'Arcy: May I ask for Professor FitzGerald's opinion on the establishment of NAMA?

Professor John Fitzgerald: I think it has done a pretty good job. It looks as if the State, instead of losing money, is going to get something back. There was much concern when it was set up - this is taking me a bit beyond what I expected - that it would be used to recapitalise the banks, to make life easy for the banks. We now know that, if anything, it was a bit tough on the banks. The discounts that applied to the assets were appropriate or maybe even bigger than necessary. I think it has helped in terms of the recovery and sorting out the problem. The concerns which were expressed when it was set up have turned out to be totally wrong. Partly because of that, because NAMA wanted to do a good job, the criticism was that it would be kind to the banks, it made sure it was not kind to the banks.

It is not my area of expertise.

Senator Michael D'Arcy: May I ask Professor FitzGerald's opinion on the national bailout?

Professor John Fitzgerald: I have published on this. If the Chairman wishes, I will go down that route.

Chairman: I am aware that the committee at the context phase of the inquiry wrote out and gave a broad scope as to the area we may be going into. I know this is an issue that was not flagged with Professor Fitzgerald for this morning and that the Senator is going into areas that were not part of his preparation. If he wishes to respond I will give him space to do so.

Professor John Fitzgerald: I will do so briefly. In a paper on budget perspectives 2012 or 2013 - I have updated it since - I looked at the approach taken in Ireland and the approach taken

Deputy Joe Higgins: In Professor FitzGerald's mind, when he is publishing these various reports, he says he is not influenced by, say, pressure from various sources, such as the Department of Finance or whatever. Has he felt a pressure to play down bad forecasts because of the nature of the system, the volatility of the capitalist marketplace or, for example, a fear that a bad forecast might frighten the horses and cause shares to fall or something like that? Does that feature?

Professor John FitzGerald: No. Our job is to call it as we see it, without fear or favour. I suppose we all live in society and I suppose, subliminally, there may be an effect but, certainly, in terms of any overt pressure, because of our independence, the danger is we will over-react to it. Over the last decade, much of our time was spent saying, "You may think things are going well but actually there is a danger there". That was the continual refrain. It was not popular politically to say that but we said it. To give the political system its due, it continued to stump up the money for the ESRI's grant and did not try to use that to influence us. We have never felt pressure to modify what we say.

Deputy Joe Higgins: The introduction to the 2008 medium-term review, referring back to the same review of December 2005, stated, "While in that review we did not want to overdo the sense of foreboding, mindful of the fate of Cassandra, [we] still wanted to alert readers to our concerns", and it helpfully footnoted that Cassandra was a figure in Greek mythology. She displeased the Gods. Did the ESRI in any way feel like a Cassandra of the modern period and that, if it was too blunt as to the dangers in regard to what was happening then, like poor Cassandra, the political and economic Gods might seek to take revenge in some form?

Professor John FitzGerald: Unlike Cassandra, we would all be conscious of the fact that we are not infallible. In the 2005 medium-term review, if the Deputy had asked me at the time, and I think a journalist asked me, what probability I would have put on a housing price collapse, I would have said a third, but by late 2006 and early 2007, it was at least a half. However, in terms of pressure with regard to the 2005 medium-term review, my feeling is that it did not go down well politically. We did not have any interaction with politicians or the Department.

There is one instance where I do feel there was upset but it was probably at a high level in the Department of Finance and possibly not with the Minister. It was in our 2006 report for the Department of Finance where we said, "You have got to take money out of the building construction sector, it is dangerous". The high level in the Department of Finance was unhappy with our conclusion.

I presented the results at a seminar, on at least one or two occasions, with the then Minister, Deputy Cowen. He knew we disagreed but as a politician he knew people disagree all the time. I did not feel that he was upset but there was, I know, upset with our conclusion.

Deputy Joe Higgins: The professor said he does not like to campaign and was not comfortable moving from research. In the same introduction of 2008, he said:

> However, our essential message in this review is upbeat, recognising that there is a danger that Irish society could be transfixed by the current very real difficulties, missing the opportunity to plan and prepare for a better future in the next decade.

Does that paragraph not show he abandoned his role as an economic scientist for a motivational preacher?

Professor John FitzGerald: I think that was a bad paragraph. I am sorry about it. I regret it and I will regret it until the day I die. I feel that I did a reasonable job on many other things but on that I did a bad job.

Chairman: I wish to interject and shall give Deputy Higgins back some time.

The professor has acknowledged his regret on several occasions this morning. I advise members of the committee not to repeatedly ask the same question in order to get him to say it on the record. At this stage the professor has stated his regret between eight or ten times.

Professor John FitzGerald: It is like confession.

Deputy Joe Higgins: Is it possible that during the pre-crisis period that the professor and the ESRI reports were fixated on workers' wages and wage restraint? In the 2005 medium-term review wages were mentioned 86 times, mostly demanding wage restraint. At the same time, was he silent on the massive increase in profiteering within the housing industry and the huge burden that was placed on the same workers to try to buy a home and meet the mortgage payments?

Professor John FitzGerald: Our successive models on how the labour market operates is not that there are nasty trade unions looking for loads of money or that workers are looking for too much. It is that the labour market produces an outcome or it is an outcome of a market.

In terms of the growth in wage rates, this was not a moral statement that workers were getting too much or trade unions were looking for too much. I suggest the Deputy looks at our analysis. We said the economy was growing too rapidly and the housing market was growing and expanding. As I said earlier in my statement, in order to get the resources to build, and let us remember 14% of the economy was housing but it should have been between 5% and 6%, the Government had to bid resources away from elsewhere. How does one do so in the labour market? One raises wage rates. The outcome was a rise in wage rates which crowded out jobs. I mentioned we were destroying jobs - jobs in DELL and other jobs were going. The problem was not that people were looking for too much money. The problem was the building sector was too big and that put inflationary pressures on the economy, which was unwise.

Deputy Joe Higgins: There was speculation in building lands and developers and bankers made huge profits on the backs of young working people trying to buy a home. Did the professor ever come at the issue from that angle?

Professor John FitzGerald: In terms of tax measures, there was a decision to get rid of the higher capital gains tax on land in I think the 1997 budget. There was a whole range of things such as the inefficiencies and the problems in the building sector. The builders did well. Economic theory tells one that with a fixed factor the people who will make a load of money will be property developers and the owners of land. The failure to deal with this matter was a very bad mistake. We have had tribunals on this issue. It is where big money was made and the matter should be dealt with.

Deputy Joe Higgins: The professor referenced that the international crisis was a huge factor in the crisis that happened here and its extent. At the same time, he referenced Professor Morgan Kelly of UCD and articles he wrote in December 2006 and then in 2007. The articles he wrote predicted that a huge crisis would be due to what was going on in Ireland without the international crisis. I ask Professor FitzGerald to comment on Professor Kelly's article dated 28 December 2006 in which he said:

> If, however, we look at what has happened to other small economies where sudden prosperity and easy credit drove house prices to absurd levels, we should be very worried indeed.

Then he mentioned the potential for house prices to fall by between 40% and 50% and a collapse of the housing building industry. He referenced Finland and continued:

> With low interest rates, and loans available for the asking, house prices soared. Then, as the Soviet Union collapsed, unemployment rose and house prices started to fall, creating problems first for builders, then for homeowners, and finally for banks. But why can't we just have our soft landing, where prices stay fixed or rise slowly for a while? Definitely not: a soft landing is not so much unlikely as contradictory.

On construction, he continued:

> In Ireland, if and when the fall occurs, it will be from about 18 per cent of all national income. We could see a collapse of Government revenue and unemployment back above 15 per cent.

He concluded:

> Pilots define a soft landing as one that you can walk away from. Looking at the collapses in Finland and The Netherlands and the building bust in Arizona, Ireland could be heading for what they call CDIT: controlled descent into terrain. You are happily descending through cloud, thinking yourself at a safe altitude, until suddenly you smack into a hillside.

The article was published on 28 December 2006. Some of those views were repeated in the medium-review article of 2007. Should it have been clear to people like the professor and others, not to mention the Government and other pillars of the establishment, that a disaster was in train?

Chairman: We will wrap up after this section.

Professor John FitzGerald: That article was excellent. It was so good that I got on to Professor Morgan Kelly and asked him to say it again in an article for the quarterly economic commentary, and he did. I asked him to do so because his article was repeating what we had said in the medium-term review in December 2005 where we looked at a fall in house prices of one third which would give rise to unemployment rising above 11%. Since 2005 and up to the end of 2006, house prices continued to rise so I felt it was sensible. It was great the he was coming out and somebody else was making the running on this. I said to him that I would like him to submit an article. He did so and we published his article with which I totally agreed.

In the spring 2007 quarterly economic commentary, my colleagues talked about the risks to the financial sector, so we got it right. What is interesting, under FOI, and this may come up later - is it in Nyberg or under FOI - is the reaction of the Department of Finance; they saw it and they rewrote it for the Minister, saying the ESRI expected a soft landing where we said there could be a soft landing. There could have been but we were uncertain because one cannot know the future. The mistake was 2008 for six weeks.

Chairman: I thank Deputy Higgins and Professor FitzGerald. I propose we suspend the meeting and resume at 11.25 p.m. Is that agreed? Agreed.

Sitting suspended at 11.10 a.m. and resumed at 11.30 a.m.

Chairman: I propose that the committee resume in public session to recommence our engagement with Professor FitzGerald. Is that agreed? Agreed.

Deputy John Paul Phelan: I welcome Professor FitzGerald. I want to start by referring to a couple of previous answers he has given. He spoke earlier about how he noticed a cultural change in the Department of Finance in the last decade of his time in the ESRI, and that some of its observations had become more political. I am interested to know whether, after the economic collapse, he noticed a change in that attitude again, or whether it remained like that.

Professor John FitzGerald: There has been a change again. The Department of Finance is a completely different place. They have got a load of economists who are doing interesting work and they are publishing it. It is in the public domain in articles in *The Economic and Social Review*. I have worked with them on a number of things. It is fun, they are encouraged to think outside the box. It is a very different world. I enjoyed working in the Department in the 12 years I was there. There was a team of very good economists and we were encouraged to disagree and so I think we have seen a cultural change back to a Department of Finance which I think is doing a good job.

Deputy John Paul Phelan: Can I ask - the professor referenced this himself as did a few of the previous witnesses, particularly the authors of the reports - if you were surprised that so few qualified economists were working within the Department of Finance at the time of the collapse, and did that have any effects on judgments that were made, in his opinion?

Professor John FitzGerald: First, I said on Vincent Browne's programme----

Deputy John Paul Phelan: We have all said things on the Vincent Browne programme.

Professor John FitzGerald: In January or February 2009, I said that the problem in the Department of Finance was that it had a number of very bright economists, but too few people working on economics. It was brought to my attention that there were a very large number of people with economics qualifications in the Department of Finance at the time but that was not the problem. I have worked in the Department of Finance and it is one thing having a qualification and another being a practising economist. It is a culture where you talk together, you disagree, and that was the kind of culture I had grown up in. I learned much of my economics in the Department of Finance but the numbers working in the area were very small. I suppose it was symptomatic of the culture - one of the reasons I left the Department of Finance in 1984 was that I was told if I wanted to be promoted I had to stop being an economist and go and do something different. I wanted to be an economist, so I left.

The HERMES model of the Irish economy was developed as part of an EU contract originally in the late 1980s, which my colleague John Bradley won. The results were published in a book by North-Holland - one of the best academic publishers - edited by the European Commission in 1993. Two of the authors were Department of Finance officials so they participated in this area. They continued to use it, but then the Department cut back the resources in that area and by the end of the decade was relying totally on the ESRI to do that kind of work for it, so that the Department put a much lower priority on work on economics. Certainly in the last decade I felt there were some really good people but too few of them and I think it showed.

Deputy John Paul Phelan: Was that a conscious decision within management in the Department of Finance, in your view, or was it something that just evolved over time?

Professor John FitzGerald: I think it evolved and there may have been some consciousferent way. In terms of the economics literature, the use of fiscal policy to manage the cycle had gone out of fashion, as the Senator is probably aware, saying fine tuning is not possible. This is not fine tuning, this is stopping disaster by using fiscal policy differently. Hopefully we have learned our lesson. It is something which need not have happened but did happen.

Senator Sean D. Barrett: A Nervous Nellie man in the Department of Finance.

Professor John FitzGerald: It could be a whole section; I do not know.

Senator Sean D. Barrett: Were views expressed to Professor FitzGerald in the controversy about the regulator for the financial sector, whether it would be in the Central Bank or entirely separate? Were telephone calls made on that issue?

Professor John FitzGerald: On which?

Senator Sean D. Barrett: On the McDowell report on how to regulate the financial sector inside the Central Bank.

Professor John FitzGerald: I was in Warsaw so I do not know whether it was in writing or on the telephone that the communication came to the director. The director discussed with me the concerns of the Department and it made it very clear that this was political. If they come up with arguments rounded in evidence one takes it seriously; there was no evidence, they just did not like it. I cannot tell the Senator because I only became aware of this last night and have not had an opportunity to trawl through. No doubt, under FOI, the committee can ask the Department of Finance if there were any communications and go after that.

Senator Sean D. Barrett: Did Professor FitzGerald have a policy on the best way to regulate banks that caused this telephone call or how did it arise?

Professor John Fitzgerald: When Patrick Honohan left in 1997 it left a gap in terms of doing research in the financial sector and we still had some funding and Mr. Colm Kearney joined us in 1998-99 but only stayed a year and is now in Trinity College. He may have moved to Trinity on the day before I came back from Warsaw; I am not sure, it was around that time. He was doing research in this area. I went back and looked at his article last night in *The Irish Times* which was really good. In regard to the serious mistakes being made, his argument was that the report done on separating the regulator used no evidence, did not look at what was going on outside and it was a bad idea. The Senator can read it in *The Irish Times* of 15 October 1999. It was a good article. He had done research in the area and had expertise. It should have been published but it was published a few days later in *The Irish Times*.

Senator Sean D. Barrett: For my last question, did Professor FitzGerald meet any contrarians in the banking system itself? Did any of the bank economists express concern to him? Did they see their own companies going over a cliff?

Professor John Fitzgerald: I was approached soon after the medium term review was published in December 2005 by people from AIB who said that the board was concerned that the stress tests prescribed were not stressful enough and asked if we would be prepared to do work. I said: "Look, at what we have done in the medium term review with a 30% housing price crash. You can pay us to do more if you want, but I think that is probably enough to give you." Also it was consistent with unemployment rising to 11% and so on. They said they would go off with it. What they did with it, I do not know but as far as I can remember, this initiative did not come from the AIB team, this was coming from somewhere higher in the bank.

Chairman: Before I move on to the next speaker may I put one question on that to Professor FitzGerald? In the stress testing proposal that AIB brought forward to him, was the issue of credit concentration limits actually part of that examination?

Professor John FitzGerald: In our role we did not want to get too involved with banks. We did macro-economic scenarios. The difference compared to what the Central Bank and so on was doing was that we used a model, so it was consistent. One did not get a housing price crash and no change in unemployment; one got a housing price crash, unemployment going through the roof and Government revenue collapsing, all coming together which is the way to do it. That was my concern. It was not just the Central Bank. It was interesting doing something similar with a British owned bank. The Bank of England and the Financial Services Authority, FSA, had a similar inappropriate approach to stress testing. I also learned from a third bank where we provide macro-economic scenarios because one of the scenarios it wanted to look at was a liquidity crisis. I should have paid more attention to what I learned from that bank because it was one of the factors that provoked the crisis.

Deputy Eoghan Murphy: I thank the Chairman and Professor FitzGerald. I want to look in the first instance at the relationship between the ESRI and the Department of Finance. I think Professor FitzGerald said earlier that in the interactions between the ESRI and the Department of Finance, he clipped them and they would grin and bear it but then in the last decade they became more grumpy. When he released the 2005 medium term review there was a different reaction, a tone change and a lot more media attention around it and much more coverage. Did Professor FitzGerald pay attention to that reaction to the medium term review in the press?

Professor John FitzGerald: We felt that we were fairly reported. One cannot say it was front page headlines in *The Irish Times* and the *Irish Independent*. As is its style, *The Irish Times* editorial did not have the sequentials to at Christmas. The reporting was out in the open. It was not that our reports were a secret. Over the decades in the institute we felt we had a duty to communicate our results to the wider public. We do not conduct reports for the Department of Finance, we do them for the people of Ireland. The press conferences are very important and the press has been extremely helpful. Some of them, great journalists such as Brendan Keenan and Paul Tansey, would always explain better what one was trying to say. The reporting was very good.

Deputy Eoghan Murphy: Was Professor FitzGerald then aware of any official reaction from Government?

Professor John FitzGerald: No.

Deputy Eoghan Murphy: Nothing comes back as feedback directly.

Professor John FitzGerald: We would have had technical comments. I could not find the file on what the Department said on that particular medium term review. I do not remember much kick back from it. In terms of doing a medium term review, we produce a draft set of numbers and send it to a large number of people, not just to the Department of Finance and the Central Bank but to other organisations to get feedback. We then get feedback and revise our numbers. When we talk to IDA Ireland and it says it has a real problem bringing in firms that should colour what we do. We would have discussed it in advance but I cannot remember a particular kick back from the Department of Finance on that one.

Deputy Eoghan Murphy: Was this the medium term review where there was an accusation of economic treason against-----

Professor John FitzGerald: No. That was 1999 and it did not come from the Department of Finance but from another public body and the Department of Finance was supportive.

Deputy Eoghan Murphy: From what public body did it come?

Professor John FitzGerald: I would have to check back. This came up last night. I am no longer in the institute and it is in the files of the institute. The word used may not have been "treason", I cannot be certain, but that was the import of my understanding. I am relying on memory, which I have had to dredge up overnight. If I had received notice this was going to happen, even a day earlier, I could have gone to the ESRI.

Deputy Eoghan Murphy: That is fair enough.

Professor John FitzGerald: This was in 1999, it came from outside, not from the Department of Finance, and the Department of Finance said, "You are independent. We disagree with you but you are perfectly right to do what you are doing".

Deputy Eoghan Murphy: Bringing us up to 2006, then, the Department of Finance commissioned the investment priorities report. In that, you were worried about the over-ambitious national development plan and a series of consequences for the economy. You already mentioned the over-inflated building sector. This was all reported in the media. You said, I think, that the Department of Finance was both upset and cross. You mentioned that you had spoken to the Minister but it was not coming from the Minister.

Professor John FitzGerald: I do not know. It was coming from the top. I do not have access to the Department of Finance files but the team working on this, the experience - I said I wanted somebody from the Department of Finance to ride shotgun with us, to go to all the meetings with everybody else because we learned a lot from it and I also felt they would too. The members of the team working on it worked very well and I think they were happy with the result although they may not necessarily have agreed with all of it. It was at a more senior level in the Department - my understanding was that they were unhappy.

There is other material on this. Harry McGee, in *The Irish Times* in October 2012, had two pieces where he got information under freedom of information. When we did the 2003 report and said that building construction was too hot and that money should be taken out of the sector, I got the impression that the Department of the Environment was unhappy with it, although I did not get that impression in 2006. What we now know as a result of the Harry McGee stories - or maybe Peter Nyberg, but I think it was Harry McGee - is that the Department of the Environment wrote to the Department of Finance in 2005 about its concern and the then Minister of State, Noel Ahern, the former Taoiseach's brother, got on to Finance to say his Department was concerned about the dangers. Within the Administration - I had heard this independently from the Department of the Environment - they were concerned about the issue. They did not disclose that in our meeting with them but they took action and said they also were worried.

Deputy Eoghan Murphy: How was this unhappiness with this in 2006 conveyed to the ESRI, this unhappiness at senior levels?

Professor John FitzGerald: It was not conveyed directly to me or the other main author, Edgar Morgenroth. My understanding is that there was a conversation with the director but this is hearsay - I do not know. What I do know is that in the comments to the medium-term review

2008, there was one reference which they still resented.

Deputy Eoghan Murphy: Coming up then into 2008, you spoke about the relationship with the Department being frosty prior to the guarantee. Did 2006 damage that relationship? Was there a chilling effect then, potentially, on the work of the ESRI?

Professor John FitzGerald: No, there are a lot of good people in Finance and they have different views and we would have worked closely with a team on the report. We had a very good relationship there. There would be nervous Nellies somewhere - I probably used an inappropriate phrase - and there are different people in the Department of Finance. What I do know is that it was at senior level, the concern about the 2006 report. Whether it was shared below or whether there were diverse opinions within the Department I do not know.

Deputy Eoghan Murphy: How was that relationship frosty in 2008?

Professor John FitzGerald: I got the impression that, whereas before, the role of the Department of Finance was such that policy proposals come from Government and the officials evaluate them and advise the Minister, say that they are unwise and so on. There was now a feeling at the top that you did not want to disagree or present difficulties, that the culture had changed. They seemed to be more concerned about the institute. They would always have said, for example, we were wrong on some aspect and they would express disagreement but one would know it was political. You know they are playing a game and you are playing a game, they have got to do it and you ignore it. However, they seemed to take it more personally, which surprised me. Where normally in my experience with Department of Finance officials the impression was it was accepted we had our job to do, that we were independent and could advise a course of action was unwise but that if the Government wanted to take such a course then the officials would have to act accordingly. Some of them seemed to buy in to what was happening in a way which was out of character with the past 30 years and out of character with what happens today. This is an impression based on limited interaction with the Department but much more research would need to be done on this before a judgement could be made on it.

Deputy Eoghan Murphy: So am I then right in thinking it was frosty on both sides? The ESRI had a particular view of the Department of Finance and the Department had a particular view of the ESRI.

Professor John FitzGerald: Yes, and we probably were not very - when we felt they were being inappropriate, they probably found us not very nice to deal with either because, as I indicated earlier, if somebody tries to beat us up we react by doing the opposite. Now one should be balanced on all occasions and there may be one or two occasions when our response to the Department might have been undiplomatic, I do not know, but-----

Deputy Eoghan Murphy: When it gets to 2008 and the medium-term review, is there a sense of either fatigue in the ESRI, given that previous medium-term reviews maybe had not been regarded as you hoped, or is there an attempt to rebuild a relationship there?

Professor John FitzGerald: There was no issue about rebuilding a relationship. The mistake in the 2008 one - we did not know where the economy was going and we made a serious mistake. There was more limited interaction with the Department and it came back with comments which were grumpy and - as I mentioned, that is probably an inappropriate phrase - but which were not that useful. They certainly were not telling us, “You are to say it is going to be a soft landing”. There was no suggestion, that was our mistake, unforced, my mistake, unforced.

this morning.

Chairman: You have only a minute.

Deputy Eoghan Murphy: In his opening statement, Professor FitzGerald said, "The dangers the economy faced as a result of the over-inflation of house prices, the build-up of debt and the loss of competitiveness in the economy were foreseeable and [as set out in the appendix] foreseen." The appendix contains the implications for fiscal policy of the analysis in the ESRI quarterly economic commentary and the medium-term review in the period 2001 to 2008. He contends that the dangers the economy faced were foreseen by the ESRI and published over the period. Am I correct that Professor FitzGerald conveyed some of his warnings to the European Commission and the IMF and asked them to intervene with the Government, and they said they could not?

Professor John FitzGerald: Yes.

Deputy Eoghan Murphy: When the warnings were conveyed to the Department of Finance, the work of the person reporting on Professor FitzGerald's reports was amended internally so that it was not conveyed appropriately to senior level.

Professor John FitzGerald: I learned that only in the past year or two as a result of the operation of the media through freedom of information. I publish reports and would be normally totally unaware of what happens to them in the Department of Finance. This is all I know about what happens in the Department of Finance. The Deputy knows as much as I know.

Deputy Michael McGrath: Could I clarify the difference between the work Professor FitzGerald did for AIB, Ulster Bank and PTSB and the work he did not do for AIB subsequently? Was it that AIB wanted him to do stress tests as opposed to just framing macroeconomic scenarios?

Professor John FitzGerald: It is not clear to me that AIB wanted me to do it, but I was very clear that I was not going to do it. There was a line. I was prepared to do work that would be in the public domain. The ESRI does research to be published without censorship. My concern was that to do a private good which I would not be able to publish would be contrary to the remit of the ESRI.

Deputy Michael McGrath: What was AIB's specific request in early 2006?

Professor John FitzGerald: AIB just wanted the macroeconomic scenarios and I do not think either of the other banks wanted me to go further than that. They were not inviting me into the spider's web.

Deputy Michael McGrath: At the meeting when AIB expressed concern that there would be no stress test by the Central Bank, what was it with a view to doing?

Professor John FitzGerald: AIB wanted me to do specific macroeconomic scenarios for it, which it would then apply. I said I could do it, and AIB could pay the ESRI, but referred the bank's representatives to a CD that anybody could buy for €250 and which contained the scenarios it wanted. It bought the CD, and what use it made of it the inquiry can ask AIB.

Senator Marc MacSharry: I thank Professor FitzGerald for his honesty and candour. Given all that we know now and Professor FitzGerald's expertise, what course of action would he have recommended on the night of 30 September 2008?

NTMA Fiscal Risk Unit / Department of Finance Fiscal Policy Division

Meeting

Wednesday 10 July 2013, 10.00am – 11.00am

Department of Finance, 14-16 Upper Merrion Street

Attendees

<u>Department of Finance (DOF)</u>	<u>NTMA</u>
John Palmer	Michael Cunningham
Niall Feerick	Alan Mahon
Patrick Quill	Dearbháil Delaney
John Murphy	

Minutes

1. The minutes of the 12 June meeting were formally agreed.

2. DOF briefly discussed Exchequer revenue and expenditure developments in the period to end-June.

3. In terms of the overall outlook for 2013 DOF indicated that the -7.5% of GDP GGB target for 2013 is looking somewhat challenging at this point. There is a potential tax revenue shortfall against the SPU estimate of some €¼ billion, mainly as a result of weaknesses in consumptions taxes and the DIRT element of income tax, as well as additional EU Budget contribution related expenditure not reflected in the SPU fiscal arithmetic.

4. NTMA asked about the outlook for other revenue sources, most notably increased dividends from semi-states, which are due to deliver €100 million of the overall €3.5 billion budgetary adjustment package in 2013. DOF indicated some potential small slippage on this figure.

5. Potential upside risks include revenues from possible asset sales, which are not captured in the SPU fiscal arithmetic.

6. On the issue of potential Exchequer costs associated with the NAMA "true-up", DOF indicated that while the process was due to be completed by end-year, any Exchequer costs which might arise, would do so in 2014. NTMA stated that it had reflected this position in the movement of €1.5 billion of the EBR contingency provision from 2013 into 2014 in the liquidity profile circulated on 9 July for discussion at the EU/IMF Programme review mission financing plan meeting on 10 July. Although a potential cash hit in 2014, DOF

stated that it saw the GGB impact as occurring in 2013 although the likelihood is that this could be treated as a once-off capital transfer with no impact on the -7.5% of GDP GGB target[1].

7. There was some discussion on the EBR contingency, collateral and end-year cash balance estimates in the liquidity profile circulated on 9 July. In the context of the cash balance estimate, DOF enquired about possible delays of programme disbursements into 2013. NTMA stated that this seemed unlikely based on correspondence received from the European Commission regarding the timing of the final EFSF disbursement. NTMA noted that the end-year cash balance could potentially be of the order of €25 billion.

8. DOF Budget Strategy Memorandum (BSM) update will not now go to Government until early September. NTMA undertook to provide an update of the 2013 debt servicing outlook in the coming weeks, in light of the end-June position. NTMA did state that debt servicing expenditure in 2013 was likely to be below the SPU estimate. The extent of the underspend would to a large degree depend on whether or not the provision included in the estimate for market based debt management and restructuring activity is required. NTMA stated it would naturally have a firmer handle on this in September for the EDP/Budget estimates.

9. On the ESA/EDP swaps issue, DOF outlined that the situation was unchanged but that it would keep the NTMA informed in the context of the issue next being on the agenda for the EFC. NTMA is preparing a note on the issue for the DOF representative at EFC. NTMA also said that it had contacted other debt management offices about this issue and that they were both unaware of it, and concerned about its potential implications.

10. In terms of the outlook for 2014, DOF listed some potential weaknesses in the numbers, including lower than planned Central Bank surplus income (CSBI) revenues and a likely downward revision to its economic forecasts, with potential knock-on negative effects for the 2014 tax revenue forecast. NTMA will provide initial, draft debt service estimates as soon as practicable in the autumn but these will necessarily only be finalised closer to Budget day in mid-October.

11. NTMA asked for an update about a request from the Irish Fiscal Advisory Council (IFAC), to DOF, for national debt cash interest estimates for 2012-2015 from the time of *Budget 2012* in late 2011 and the *April 2012 SPU*. DOF stated that there had been no further contact from the IFAC on this issue.

12. The next meeting of the group will take place in August/September, on a date to be agreed.

23 July 2013

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[1] The DOF has since reverted and subsequently informed the NTMA Fiscal Risk Unit that there is somewhat more uncertainty regarding the timing of the impact of any costs associated with the NAMA "true-up". In cash terms, it is now thought that any such impact would likely materialise at end-2013 or in Q1 2014. In GGB terms, the impact will be when the precise amount is known i.e. at the end of the process. The DOF will keep the Fiscal Risk Unit informed on this issue.

explaining the Council's positions, including in the media and before the Oireachtas Joint Committee on Finance, Public Expenditure and Reform; (iii) together with Council colleagues, oversee the work of the Council's secretariat, including the preparation of reports and the development of analytical capacities; (iv) together with Council colleagues, ensure that all governance requirements for a statutory body are being complied with; and (v) to serve as Accounting Officer for the Council.

2. How does the Council go about reviewing and commenting on the Department of Finance's macroeconomic forecasts?

The Council is required to both assess and endorse, as appropriate, the macroeconomic forecasts underlying the annual Budget and stability programme. The endorsement process, which is underpinned by a Memorandum of Understanding with the Department,[4] involves a number of steps. In broad outline, these steps are:

- Prior to receiving the Department's macroeconomic forecasts, the Council prepares its own benchmark forecasts for purposes of comparison;
- Approximately one month before the Budget/Stability Programme publication, the Council receives the Department's preliminary forecasts, which is followed by the technical presentation to the Council's secretariat;
- This is followed by a presentation by the Department to the full Council and secretariat of the updated forecasts, with an opportunity for members to query all aspects of the forecasts;
- The Council then meets to discuss the forecasts and to finalise a decision on endorsement;
- Any significant reservations are relayed to the Department;
- If the Council is satisfied that the forecasts can be endorsed, I write to the Secretary General of the Department providing our decision on endorsement;
- The endorsement decision is published together with the Department's forecasts in the draft Budget/stability programme.

In making its decision on endorsement, the Council considers: (i) the appropriateness of the forecasting methodologies used; (ii) evidence of systematic patterns of bias in recent forecasts; and (iii) deviations between the Department's forecasts and the Council's own benchmark and other available forecasts.

[4] Available at: http://www.finance.gov.ie/what-we-do/economic-policy/publications/reports-research/memorandum-understanding-between-irish.

In our *Fiscal Assessment Report* subsequent to the Budget/Stability Programme, the Council publishes its benchmark forecasts and outlines both the process and the reasons for the endorsement or non-endorsement decision. To meet the assessment component of the mandate, the Council also provides an assessment of the Department's macroeconomic forecasts, which includes an assessment of current and prospective macroeconomic conditions.

3. How would you describe the level of support the Council receives from the Department of Finance? Could you comment on the quality and quantity of resource at the Department in respect of its macro-economic work?

The Council receives very good cooperation from the Department in its review work. All technical queries are dealt with promptly and detailed presentations – with ample opportunity to question the assumptions underlying the forecasts – are given to both the Council and the secretariat.

In our experience, under the leadership of the Chief Economist, the quality of the department's macroeconomic forecasting work is of a high level. As the Committee has been made aware in previous testimony from the Chief Economist, the Department's macroeconomic forecasting team has been significantly expanded compared to the pre-crisis period. I am informed by the Department that in the economic unit there is now approximately 20 people with a background in economics. Specifically on the forecasting resources, there are seven economists at the AP/AO level, with a further vacancy to be filled in the autumn. This compares with less than five people doing economic analysis/forecasting in the pre-crisis period.

One area highlighted in our most recent *Fiscal Assessment Report*[5] in which the Department's forecasting capacities could be improved is in the production of medium-term forecasts of the potential growth rate of the economy. At present, the Department uses the harmonised methodology agreed between the Member States and the European Commission. The Department has itself repeatedly drawn attention to the limitations of this methodology for developing an adequate picture of the supply-side potential of the Irish economy. It is essential that the Government's forecasts are well-founded to provide a sound basis for ensuring that the public finances are on a sustainable path. The Council believes that this requires the development of a fuller picture of the supply side outside of the harmonised framework. To this end, the Council has recommended that the Department should also develop a set of medium-term baseline estimates

[5] Available on the Council's website at: http://www.fiscalcouncil.ie/fiscal-assessment-reports/

Wright Report on Strengthening the Capacity of the Department of Finance

Budgetary and Other Processes

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.

The Department of Finance complies with this recommendation by producing two sets of published economic and fiscal forecasts every year:

1. by end-April for the Stability Programme Update (SPU);
2. the annual Budget forecasts in October and the submission of a Draft Budgetary Plan to the European Commission by October 15th each year.

In addition White Paper (i.e. no policy change) fiscal forecasts for the Budget year are also prepared shortly in advance of the Budget. The key dates have changed in line with the EU Semester.

This forecasting cycle is in line with European requirements which have evolved since the publication of the Wright Report in March 2011. The two-pack EU regulations concerning budgetary frameworks require publication of draft budgetary plans, including economic and fiscal forecasts, by mid-October each year. The draft budgetary plan required under the two-pack is published at a stage in the budgetary semester that informs the public and political debate. This document outlines the Department's latest view on the macroeconomic and fiscal outlook as well as the risks affecting this. It also provides aggregates for the fiscal stance that is considered as appropriate for the Budget.

Publication of an additional set of forecasts just over two months after the publication of the SPU forecasts has not been deemed necessary in recent years. In addition, under the two-pack the Department's forecasts are now subject to endorsement by the Irish Fiscal Advisory Council. This provides an additional level of external assurance of the numbers.

In advance of Budgets 2014 and 2015 the Department's macroeconomic forecasting team presented its view of the outlook to the Joint Oireachtas Committee on Finance, Public Expenditure and Reform one week before the Budget. This provides an opportunity for parliamentary scrutiny of developments in advance. The Minister for Finance has also presented the SPU to the same Committee in advance of publication for a number of years.

Given these developments since the publication of the Wright Report the Department sees the publication of twice-yearly macroeconomic forecasts as appropriate at the current juncture. Given the volatility of Irish quarterly GDP, a more frequent forecasting cycle could produce confusing signals to policymakers as forecast revisions would be large. The twice-yearly cycle also fits the endorsement calendar as agreed with the Irish Fiscal Advisory Council. However the Department does not rule out additional forecast rounds on an ad hoc basis if high-frequency developments necessitate it.

On risk, both the SPU and macroeconomic text which accompanies the Budget includes a detailed section on the Department's view of the risks to the outlook. Quantitative impacts of various stylized shocks are also included.

Regarding sectoral developments, the Department has produced ad hoc working papers in recent years on, inter alia, the impact of the foreign-owned sector on economic developments.

2) **Departments would not seek spending enhancements beyond the spring consultations leading to the Budget review at Cabinet.**

Following the split of the Department of Finance into two entities, this recommendation now falls under the remit of the Department of Public Expenditure and Reform.

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.**

The Department of Finance agrees that fiscal policy should follow a sustainable path based on sound economic fundamentals. Broadly speaking, this recommendation advises that fiscal policy should be cognisant of underlying trends as opposed to one-off factors such as an upside surprise in November tax receipts.

Following the move to the two-pack the Budget is now published in mid-October and fiscal policy is based on the most up-to-date data available at that point. Therefore, any upside experienced in November has no bearing on the fiscal policy contained in the October Budget.

In addition, under the "six-pack", which amended and strengthened the Stability and Growth Pact, Member States must make an appropriate annual improvement in their cyclically-adjusted budget balance, net of one-off and other temporary measures, towards their medium-term budgetary objective (MTO). Until Member States, including Ireland, reach their medium-term budgetary objective, annual expenditure growth (excluding expenditure relating to interest, co-funding for EU expenditure and non-discretionary changes in unemployment benefit expenditure) are subject to increases below potential growth rate. However, once the MTO is reached, deviations from the Expenditure Benchmark (i.e. for expenditure increases or revenue reductions) will not be considered significant, if the MTO is maintained. In addition, Ireland cannot make tax revenue reductions unless matched either by expenditure reductions or increases in other revenue items or both.

As a result, from 2016 onwards any positive revenue surprises cannot be used for additional expenditure beyond what is permitted under the expenditure benchmark or additional tax relief. Instead it will reduce the Exchequer Borrowing Requirement and, therefore, favorably impact on our debt situation.

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 release of the Government's fiscal plan, the Fiscal Council could review:

- **the Department's economic and fiscal outlook,**
- **the Department's risk assessment,** (this is not a formal Two Pack requirement)
- **whether the proposed fiscal framework, including provision for new Government budgetary action, entails acceptable risks for the economy.** (this is not a formal Two Pack requirement)
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The Irish Fiscal Advisory Council (IFAC) was established on an administrative basis in June 2011, and became a statutory body when the Fiscal Responsibility Act 2012 came into force on the 31st December 2012. The Act also sets out the Council's functions, which can only be amended through primary legislation. This in effect ensures compliance with recommendation 4.

The Fiscal Responsibility Act (FRA) put the IFAC on a statutory basis and assigned it the monitoring and assessment functions required of an independent national institution under the Fiscal Compact. The FRA also provides for the funding of the IFAC. The provisions ensuring the independence of the IFAC comply with the European Commission's Common Principles.

The IFAC was established with a mandate to independently provide an assessment of, and to comment publicly on, whether the Government is meeting its own stated budgetary targets and objectives. The Council is also charged with assessing the appropriateness and soundness of the Government's fiscal stance and official macroeconomic projections, as well as an assessment of the extent of compliance with the budgetary and debt rules. This process took place for the first time as part of Budget 2014.

Regulation (EU) 473/2013 introduced a requirement that draft budgets and the stability programme update must be based on macroeconomic forecasts that are produced or endorsed by an independent body. This endorsement function has been set out in an amendment to the Fiscal Responsibility Act 2012 and has been assigned to IFAC.

Additional powers cannot be assigned without primary legislation. This feature along with the fact that the Councils budget is not subject to the annual budgetary procedure helps ensure that the Council's independence is fully protected.

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.**

Please refer to Recommendation 4.

6) **The Fiscal Council could also usefully assess the impact of future Social Partnership wage and fiscal provisions on Ireland's economic competitiveness.**

Please refer to Recommendation 4.

Economic and Fiscal Forecasting

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.

Firstly, under Commission regulations and the Budgetary Framework Directive, we are required to base fiscal planning on the most likely macro-fiscal scenario or on a more prudent scenario. The macroeconomic and budgetary forecasts must be compared with the most updated Commission forecasts and if appropriate, those of other independent bodies. Significant differences between the chosen macro fiscal scenario and the Commission's forecast have to be described with reasoning, in particular if the level or growth of external assumptions departs significantly from the values retained in the Commission's forecasts.

Further to the information set out in respect of Recommendation 1, Departmental publications that provide economic and fiscal forecasts set out emerging risks, both positive and negative, to the emerging economic and fiscal outlook. In addition, Government is informed of risks as appropriate throughout the year, including in the mid-year Macro Fiscal Update (MFU). Of course the risks to the economic outlook have implications for the public finances but there are also risks, separate to those associated with the general economic situation, which can have very serious consequences for the public finances. These too are identified in the MFU.

Quantitative sensitivity analysis of fiscal and economic outcomes analysis to changes in global growth and the savings rate (respectively) is conducted as part of on the Department's forecasts and presented in both the SPU and Budget documentation. A qualitative assessment of macroeconomic and fiscal risks is also set out.

Details of engagement with economists and academics from the public and private sector that also assists in developing positions on risk analysis is provided in response to Recommendation 8.

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.

The Department regularly meets with and briefs, as part of its day-to-day operations, credit rating agencies, potential investors, international institutions. In recent years the Department has considerably increased its level of interaction with economists from elsewhere in the public sector and in the private sector. For example, the Economics Division has since January 2011 held a series of seminars with private and public sector participation. Seminars have been held in the context of the past four Stability Programme Update to discuss the macroeconomic and fiscal forecasts as well as the risks associated with those forecasts.. A further seminar was held on estimation of the output gap and the structural balance in January 2012 and again in November 2013. In November 2013 a Chief Economist was recruited via external competition. His role includes the public communication of the Department's view of the outlook externally in various forums.

Advice over the Budget Cycle:

9) **The Department of Finance should keep a written record of advice tendered and decisions taken as part of the budgetary process.**

Each year, as the Budget approaches many Pre-Budget Submissions are received by the Department primarily from individuals and from representative groups. Each Submission is recorded and filed. A copy is sent out to officials who are responsible for the relevant policy area. The Department also circulates these Submissions, as appropriate to the Department of Public Expenditure and Reform.

A summary of the principal Submissions is also circulated as a Paper to members of the Tax Strategy Group (TSG). This Paper, along with the policy papers on Budget options which are also prepared by various Departments for the TSG, are subsequently published by the Department of Finance (further details of the TSG are at (16) below).

Written submissions on various options are prepared for the Minister. The Minister will decide, in consultation with the relevant officials, whether or not a particular option should be pursued. These decisions are recorded in writing. Options which have been approved by the Minister are then included in the Budget and Finance Bill process which, of course, is subject to Oireachtas scrutiny.

10) **The Panel strongly supports the public release of substantially more economic analysis by the Department. However, policy advice to the Minister for Finance in the preparation of the Government's Budget should not be subject to release under Freedom of Information for at least five years.**

See response to recommendation 42 as regards the publication of economic analysis papers by the Department.
The recommendation that policy advice to the Minister for Finance in the preparation of the Government's Budget should not be subject to release under Freedom of Information for at least five years has not been implemented.

The reason why the recommendation has not been implemented is because it is not consistent with the Programme for Government which seeks to enhance openness, transparency and accountability of all public authorities.

The Freedom of Information, Act 2014 and its predecessors (1997, 2003 Freedom of Information Acts) govern the full, partial or non-release of policy advice provided to the Minister for Finance in the preparation of the Budget and indeed all information held or created by the Department. The Freedom of Information, Act 2014 seeks to promote and enhance openness, transparency and accountability of all public authorities. It provides for a Code of Conduct to enhance the release of information held by State bodies. As part of its work in developing a publication scheme under the Code of Conduct which is now part of the FOI process, the Department will be examining the extent to which it can proactively publish information and analysis related to the work of the Department.

Macro-economic Risks:

11) **The Panel recommends that the Department prepare comprehensive macroeconomic risk assessment for Ireland as part of its annual advice to Cabinet.**

The Department has substantially increased the level of risk assessment it carries out in relation to its published forecasts as previously set out in Recommendations 1 and 7. A similar level of risk assessment is carried out in advising Cabinet.

The Department has expanded its technical toolkit to include a fanchart platform using Monte Carlo simulation techniques. Probability bounded risk estimates using a fanchart type analysis of both the growth outlook and its impact on headline fiscal aggregates are prepared

More broadly, a National Risk Assessment[1] was published for the first time in October 2014, co-ordinated by the Department of An Taoiseach. This includes a section on economic risks which included extensive input from the Department of Finance.

12) **The Department should establish sufficient formal arrangements with the Central Bank, including its Financial Regulation function, the NTMA and NAMA and establish sufficient technical capacity internally to manage this process.**

Senior officials from the Department of Finance, the NTMA, the Financial Regulator meet on a regular basis to discuss issues of strategic importance. The 'Principals Group' consists of

- Derek Moran, Secretary General, Department of Finance
- Ann Nolan, Second Secretary General, Financial Services, Department of Finance
- Conor O'Kelly, CEO, NTMA
- Patrick Honohan, Governor, Central Bank
- Cyril Roux, Deputy Governor, Financial Regulation, Central Bank
- Stefan Gerlach, Deputy Governor, Central Banking, Central Bank

Other senior officials attend as required depending on the issues being discussed.

The Department has a Memorandum of Understanding (MOU) with the NTMA with regards to the roles and responsibilities of each party in relation to the compilation of debt data and servicing forecasts. This is in response to the internal and external recommendations on the General Government Debt consolidation discrepancy. The data provided by the NTMA under this agreement is the national debt, debt servicing requirements and the level of cash and other financial assets held. The MOU is limited in scope in relation to the statistics unit and does not cover any other areas of co-operation between the Department of Finance and NTMA.

Furthermore, there is also a Government Finance Statistics Liaison Committee (GFSLC). This Committee provides an oversight role in relation to Ireland's Government Finance Statistics, including the twice yearly Excessive Deficit Procedure (EDP) returns. Its primary purpose is to ensure that Ireland's GFS data compliers – Central Statistics Office (CSO), the Central Bank of Ireland (CBI) and the Department of Finance are accurate and comparable. The Committee also provides a forum for

[1] Available at:
http://www.taoiseach.gov.ie/eng/Publications/Publications_2014/National_Risk_Assessment_report_2014.pdf

cooperation and discussion of methodology and classification issues among the three principal GFS data compliers.

In addition, there is also a General Government Debt Expert Group. This exists as a sub-committee of the GFSLC and provides information and expertise in relation to General Government Debt and thus contributes to the on-going monitoring and improvement of accuracy, quality and timeliness of Government Finance Statistics reporting, including that required under the Excessive Deficit Procedure, in relation to General Government Debt under the European System, of National and Regional Accounts (ESA 2010).

The department's oversight of NAMA is now managed by the Shareholding Management Unit (SMU), which is staffed with banking specialists who are seconded from the NTMA's banking division. This unit is responsible for ensuring the fulfillment of the Ministerial responsibilities under NAMA legislation to ensure NAMA meets its objectives and has regular interaction with senior executives of NAMA both on a formal and informal basis and meets senior executives of the Agency on a frequent basis.

13) **The Government should introduce legislation to establish a coordinating committee of these financial agencies, chaired by the Secretary General of the Department of Finance, which would require the full exchange of any information that could entail fiscal or economic risks to the country, among the above agencies.**

As stated above in relation to Recommendation 12, stronger ties have been established between these financial agencies particularly through the 'Principal's Group' but no legislation has been introduced to cement the status of this group.

In recent months, at an operational level the Department has also increased its engagement with other State departments and bodies on the identification and management of risk, including fiscal and economic risks. Although this engagement at this level is also not supported by a legislative mandate, it has resulted in an improvement in information sharing and risk management understanding and has also led to revisions in risk management practices at many of the Departments concerned.

The Department has sought in tandem to improve its own internal risk analysis and risk management and mitigation processes. The Department has engaged extensively with the development of the National Risk Assessment process (including identification of economic and financial risks in the 2014 NRA document). The Department will work with the Department of the Taoiseach in progressing a methodology for managing and mitigating these identified risks

Construction Policy:

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

Following the split of the Department of Finance into two entities, this recommendation primarily relates to the former Sectoral Policy Division of the Department which is now under the remit of the Department of Public Expenditure and Reform.

A key part of our reform programme involves the Economics Division. This Division is resourced by expert economists in both the macroeconomic and microeconomic field with experience drawn from the private sector and elsewhere in the public service. The Department's economic resources have been increased and the Department is now conducting additional sectoral analysis as part of its economic planning and forecasting function. See response to recommendation 1 on the publication of economic research by Departmental staff.

The Economics Division, working in conjunction with other divisions in the Department, is devoting considerable attention to the construction sector at present with a particular focus on the analysis of possible constraints on housing supply, including costs levels in the sector and the availability of development finance.

Tax Policy Advice:

15) The Department should substantially increase its analytical capacity in the tax policy area.

The Tax Policy Division in the Department of Finance has a total of approximately 35 staff. Nine tax policy Graduate AOs have been recruited each of whom have a variety of tax, law and economic qualifications. Vacancies at a more senior level are now also regularly advertised publicly, for example the recent PO tax policy competition and the Assistant Secretary post in the tax policy area which was run by the Top Level Appointments Committee (TLAC).

The Tax Policy Unit in the Department of Finance has over the past five years progressively sought to increase its technical skills capacity. In this regard, the Tax Policy Unit has engaged, following a competitive tender process, with the Irish Taxation Institute to provide an externally accredited tax policy learning and development programme for its staff. This training programme, entitled the Diploma in Tax Policy and Practice, involves well over a 100 hours of tax technical training and runs over two years. The Diploma is being progressively rolled out to all staff in the Tax Policy Unit who do not already have specific tax qualifications. Nearly all of the Tax policy staff have now completed the Tax Diploma. A further 23 Department of Finance staff commenced the Diploma in early 2015.
In addition, a number of staff in the Tax Policy Unit have completed or are currently undertaking professional tax qualifications (such as the AITI Chartered Tax Advisor qualification) and a number of short term secondments to external agencies (such as the European Commission's Directorate for Taxation) to increase specialist knowledge have been organised.

Tax policy staff are also pursuing a range of other relevant qualifications including for example Master Degrees in Economics and in Economic Policy Analysis.

Separately, a specialist tax economic analysis unit has been established in the Economic Division of the Department staffed by externally recruited economists. The Head of this Unit now sits on the Tax Division's internal management committee and the Unit works very closely with the Tax Policy Division.

In line with similar programmes in other parts of the Department, the tax Policy Division has also organized a small number of short term assignments into the Department from private sector tax advisory firms and also in one instance from another EU member state.

The Tax Policy Unit has also sought in recent years to increase its interaction with external stakeholders. One example of this is the Department of Finance Tax Policy Conference, the second annual event taking place in November 2014. These new annual conferences provide a new mechanism for the Department to interact with stakeholders and publicise new tax policy research.

At the recent annual tax conference the Minister for Finance announced a new tax research partnership with the ESRI. All of this research will be published.

In addition, the Tax Policy Unit has recently established a new Tax Training Network, membership of which is available to all staff in the Department of Finance and the Department of Public Expenditure and Reform.

The aim is to put in place a contact group of people across the Department who are interested in tax policy and would like to be kept informed of upcoming tax research seminars, tax conferences and training opportunities being run by or involving the Department of Finance's Tax Policy Unit.

To date, approximately 50 people across the Department of Finance and the Department of Public Expenditure and Reform have signed up for membership of the network.

The organised events will qualify for CPD – continuing professional development – for the Irish Tax Institute and certain other accounting bodies. A growing number of staff in the Department have a range of ITI tax qualifications.

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.

As part of the annual Budget process, the Tax Policy Unit chairs and provides the Secretariat for the Government's Tax Strategy Group. The Tax Strategy Group considers approximately 10 to 20 separate Tax Policy Papers prepared by the Tax Policy Unit in advance of the Budget. These papers are published after each Budget and are available to read on the Department's website
In 2010-2011, a review of the Business Expansion Scheme was carried out and an Ex-Ante Economic Impact Assessment of the new Employment and Investment Incentive was published.

A Study on the Economic and Budgetary Impact on the introduction of a Common Consolidated Corporate Tax Base in the European Union was commissioned by the Tax Policy Unit from Ernst and Young, Washington DC and was published in January 2011.

- The Tax Policy Unit assisted in the preparation of the National Recovery Plan 2011 – 2014, published in 2010.

- The Tax Policy Unit prepared a comprehensive review of tax expenditures in 2010 in line with the provision in Section 1 of Finance Act 2011.

- The Tax Policy Unit published an Economic Impact Assessment of Potential Changes to Legacy Property Reliefs. Subsequent legislative amendments were made on foot of the recommendations in the Report (2011).

- A Review of the Film Relief Tax Scheme was completed and the Scheme was substantially amended on foot of the Review (2012).

- A comprehensive review of the R&D tax credit scheme was completed and legislative changes made to the Scheme (2013).

- A suite of research relating to Ireland's corporation tax policy was completed and this inputed into the Road Map for tax Competitiveness published with the Budget in 2014.

- A review of 26 tax reliefs related to the agri-food sector was carried out and the recommendations were again implemented in the Budget and Finance Bill in 2014.

Public consultation processes are an integral part of the deliberative process. Recent consultations include:

- legacy property reliefs;
- tax relief for charitable donations;
- tax residence rules;
- VRT and Motor Tax and
- Film Relief
- R&D Tax Credit Scheme
- Special Assignee Relief Programme (SARP)
- Foreign Earnings Deduction (FED)
- Seed Capital Scheme (SCS)
- Employment and Investment Incentive (EII)
- Agri-taxation Reliefs.

Building on the experience of the above reviews and on best practice internationally, the Department published guidelines for the evaluation of tax expenditures (covering both ex ante and ex post evaluation) with the Budget in 2014.

Medium Term Analysis:

17) The Government should commit to the preparation of regular medium- term economic plans for Ireland at least every five years.

In December 2013, the Government published its Medium Term Economic Strategy 2014-2020 (MTES). The Strategy sets out broad policy orientations and specific actions to achieve job-rich economic recovery. It provides an overall framework for social and economic policies that are being developed and implemented by the Government over the period from 2014 to 2020.

The MTES has a number of key objectives:

- to set out a path for economic growth to full employment;
- to provide an overarching whole-of-Government strategy to which other sectoral and horizontal policies and strategies are aligned;
- to identify new strategic priorities that will make the biggest impact to increase the economy's potential growth;
- to maintain the discipline and reform momentum achieved under the EU/IMF programme;
- to set out the fiscal parameters and targets required under both the EU Stability and Growth Pact and the Fiscal Compact; and
- to ensure that the mistakes of the past are not repeated.

These objectives are within the Strategy's three pillars:

- Ensuring Debt Sustainability
- Financing Growth
- Supporting Employment and Living Standards

Department's Interface with Other Departments:

18) The Department should integrate those sections of Public Service Management and Development Division dealing with administrative budgets into Sectoral Policy Division to create a "single window" interface with line Departments.

Following the split of the Department of Finance into two entities, this recommendation now falls under the remit of the Department of Public Expenditure and Reform.

19) Activities could be organised immediately under the Assistant Secretary level in the Sectoral Policy Division. The longer-term objective should be to establish Principal positions responsible for the interface of all activities with outside Departments.

Following the split of the Department of Finance into two entities, this recommendation now falls under the remit of the Department of Public Expenditure and Reform.

Public Service Management and Development:

20) Public Service Management and Development Division should be established as a separate entity, either as an entirely separate Department or reporting directly to the Minister of State for Public Service Modernisation.

Following the split of the Department of Finance into two entities, this recommendation now falls under the remit of the Department of Public Expenditure and Reform.

21) The Secretary General of the Department of Finance and Minister for Finance should retain authority over the overall wage bill, negotiating mandates for new collective bargaining processes and manage a single window on departmental control functions.

Following the split of the Department of Finance into two entities, this recommendation now falls under the remit of the Department of Public Expenditure and Reform.

Public Service Modernisation:

22) The Panel strongly supports the creation of a Private Sector Advisory Board which it understands is under consideration by the Departments of the Taoiseach and Finance.

Following the split of the Department of Finance into two entities, this recommendation now falls under the remit of the Department of Public Expenditure and Reform.

23) A full-time Task Force should be established and assigned responsibility for driving forward the reforms under the Croke Park Agreement.

Following the split of the Department of Finance into two entities, this recommendation now falls under the remit of the Department of Public Expenditure and Reform.

24) The Task Force would comprise existing staff from the Modernisation Unit of the Department. The Task Force would also include key individuals from the leading

Departments along with expertise in the area of change management on secondment from the private sector.

Following the split of the Department of Finance into two entities, this recommendation now falls under the remit of the Department of Public Expenditure and Reform.

25) **The Task Force's Team leader should have direct access to the Minister of State responsible for Public Service Modernisation.**

Following the split of the Department of Finance into two entities, this recommendation now falls under the remit of the Department of Public Expenditure and Reform.

26) **In addition, there is a need to recruit expertise in the areas of change management and business process re-engineering.**

Following the split of the Department of Finance into two entities, this recommendation now falls under the remit of the Department of Public Expenditure and Reform. The Department has however developed skills in this area within its Corporate Affairs function.

Core Finance Functions:

27) **With the possible exception of the Public Service Management and Development Division, no other core functions should be moved out of the Department of Finance.**

The Department of Finance split has been more substantial than this. Further details on the revised structure of the Department of Finance after the split is provided below in Recommendation 28.

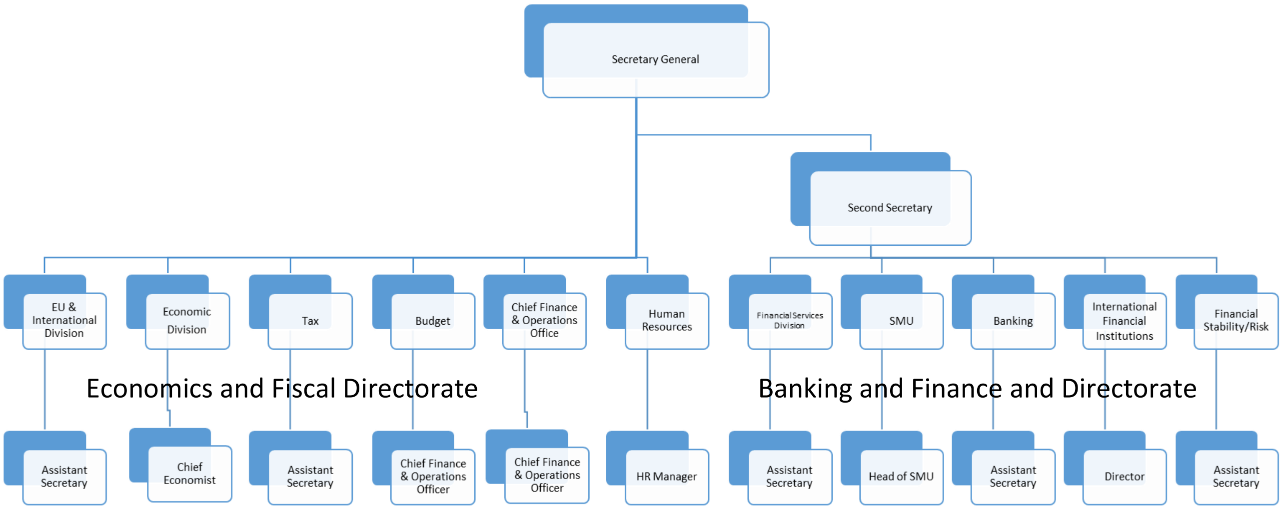
Structure:

28) **Assistant Secretaries should report directly to the Secretary General of Finance.**

Our Organisational structure derives from our core job of providing policy advice to the Minister and the provision of the infrastructure that is integral to support that role. The structure is not fixed but changes and evolves according to needs and emerging priorities.

The Management Advisory Committee examines in detail the goals and priorities of the Department and develops a resource plan from these considerations. This involves an analysis of the skills, qualifications and experience of the existing workforce, allocating these staff across the new organisational structure and identifying the gaps by grade, skill and qualifications in each of the Department's divisions. During this process detailed division by division, area by area and grade by grade resource demands are identified, discussed and agreed. This workforce planning and resource review approach is now the process used for examining resource requirements as part of the Department's Integrated Business Planning process.

The Department's structure has been organized into 2 Directorates. Since July 2014 these are headed up by Derek Moran, Secretary General and his deputy Ann Nolan, Second Secretary respectively. Assistant Secretaries report directly to the Secretaries General.



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.

See response to Recommendation 28 above also. This issue was reviewed and addressed in the revised organizational structure. It should also be noted that the operation of MAC has changed considerably with a much greater focus at Divisional level on Business Planning, performance improvement and reporting. At the time report was completed there were two Secretaries General and three Second Secretaries General. As per response 28 there are now just one of each.

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.

The primary issue here is related to the organization of the Department of Public Expenditure and Reform. An MoU has been agreed between the Budget side in the Department of Finance and the Expenditure side in the Department of Public Expenditure and Reform to ensure that the excellent working relationships evident at this level continue in the future. The Department has appointed a Chief Finance and Operations Officer who is responsible for the development and implementation of the Department's finance and operations strategy. The Budget Office is also under his stewardship.

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.**

Response to Recommendation 28 above addresses this.

32) **The Second Secretary responsible for Financial Services should retain responsibility for this function until such time as the banking crisis is considered to have abated sufficiently. At that time the post should be abolished. That Second Secretary could draw on the support of the Assistant Secretaries currently in that Division as necessary, but they would report directly to the Secretary General.**

Addressed in responses above.

Management Advisory Committee (MAC):

33) **The remit of the MAC should be broadened to include discussion of major strategic challenges confronting the Department.**

The reorgainisation of the Department has led to significant improvements in the MAC. The MAC agenda is structured around its key business and policy challenges facing the Department. In addition the senior management grouping has been broadened to include weekly engagement with Principal Officers. Rather than four similar meetings per month, the Department has three day-to-day business meetings and one in-depth meeting per month where all Principal Officers attend. The purpose of this meeting is to review a collated comprehensive set of management information for the Department. This monthly management pack provides information on the finances of the State, the finances of the Department, performance of the economy, detailed HR information and other reports from across the Department. The other three meetings are shorter and focused reviewing the planned week's events while also looking out to the next key milestones. Corporate matters are also discussed at these meetings including governance and strategic HR matters.

The Department has identified the need for greater inclusiveness in Departmental management as one of its guiding principles and has implemented a number of initiatives. A number of standing subcommittees of the MAC, risk, policy, EU strategy, capital markets and ITC allow for greater in-depth analysis than could occur during MAC meetings. They are supplemented by ad hoc groupings of staff both within and outside the MAC to look at and make recommendations of what we might improve in areas such as internal communications etc.

34) **All those that report to the Secretary General should attend MAC meetings. Given the pace of change underway, MAC meetings could usefully include a brief report by Assistant Secretaries on key issues in their area, where appropriate, as well as Secretary General and Second Secretary reports on high level issues.**

Please see Recommendation 33 above. This recommendation is in place.

35) **Attendees at MAC should, as a matter of course, brief their own direct reports on outcomes from these meetings.**

Each MAC meeting sets out a list of actions for follow up and these are discussed by staff in the relevant divisions. Divisions also hold “divisional MAC” meetings where necessary, in order to update local staff on overall developments and to discuss areas of focus for the division. The meetings help to set the priority and focus items raised at the Department’s MAC meeting. Members of MAC also present on “Policy Perspectives” that are open to all staff.

36) **The MAC should meet more often at Budget time and during periods of major change to enhance internal communication and connect all employees to emerging issues. It should schedule regular meetings on key policy issues.**

Please see Recommendation 33 in relation to the increased level of interaction at MAC level which includes the MAC subcommittee structure.

Corporate Secretariat:

37) **A Corporate Affairs Unit, which should be headed by a Principal who would report directly to the Secretary General, should be established. It would bring together and enhance a number of functions which are located in different areas of the Department. The functions of the Unit would be to:**
   - **manage the interface with the Minister’s Office;**
   - **co-ordinate briefs and draft speeches for the Minister to ensure consistency and quality;**
   - **help ensure effective internal communications;**
   - **manage departmental outreach and the Department’s profile;**
   - **co-ordinate, on a regular basis, the preparation of a brief for MAC on all major live issues and an early warning on significant emerging issues;**
   - **help co-ordinate major departmental initiatives;**
   - **co-ordinate departmental strategy statements;**
   - **manage the activities of the Department’s Press Office; and**
   - **manage the Freedom of Information function in the Department.**

A Corporate Affairs Office has been established with responsibility and liaison for the areas noted. In particular the office is responsible for maintaining the Department’s governance framework, coordinating the development of and monitoring execution of strategy and divisional business plans, building a project management capability and providing project management services managing the governance framework of the Department.

The Department recognises the importance of engagement with all bodies under the aegis of the Department and is developing a control framework to support this process to ensure that at least the minimum extend of oversight is achieved. The overarching control framework will ensure consistency of the monitoring process, in terms of proportionality, use, quality and control, is undertaken for all bodies under the Department’s aegis.

Structure at the Working Level

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.

Please see response to Recommendation 28 above.

Enhancing the Department's technical skills:

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.

An assessment of the staffing levels was undertaken by senior management in the Department of Finance in October 2011 as part of the 2012 Estimates process. That exercise examined the staffing levels at that time following the split with DPER, the shortages in skills and expertise in a number of key areas and the challenges that faced the Department, the economy and the Government.
Two broad issues were identified as facing the Department at that time;

i. Addressing the skills and expertise shortages
ii. Meeting the major policy challenges which are integral to the Programme for Government including
    - the reform of the banking system,
    - meeting increasingly onerous requirements from the EU in relation to development of financial services,
    - compliance with the EU/IMF Programme and
    - a need to significantly broaden and deepen Ireland's interaction with the EU and the other international institutions

The Department received an increase in the Employment Control Framework (ECF) in the 2012 Estimates from 282 to 320.

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.

See response to 43 below.

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.

HR have developed and streamlined the induction process for new entrants, which assists in effectively assimilating all new staff into the Department, by clarifying the roles and functions of the

Department, the Statement of Strategy, the restructured Departmental Divisions and Sections, while making relevant information available to new staff, e.g. policies, procedures, circulars etc.

The Induction Programme is continuously reviewed and updated. The review being undertaken currently is looking at developing the Sharepoint Site to include video material, links to other sites and areas of interest, plus the classroom activities. It is envisaged that the Secretary General and other managers will be available to meet with new staff to discuss the various Divisions and a tour of the Dail will also be included in the Induction Process.

The Department launched its Learning and Development Strategy in October 2014. The Department is championing the 70-20-10 learning model and staff engage with learning on the job, through coaching opportunities and at formal learning initiatives. Lunch and Learn activities along with Policy Perspective talks across the Department are carried out and staff are invited to attend these hour long presentations as development opportunities. Staff are also encouraged to continue with professional development through engagement with the Refund of Fees Scheme and CPD activities. Department of Finance staff have attained both national and regional awards from the Institute of Project management in both their Strategic Project Management and Certified Project Management Diploma courses in 2014 and 2015 respectively. The Department has also been shortlisted as Best Learning and Development Organisation (Medium Size Enterprise) 2015 in the Irish Institute of Training & Development (IITD) national training awards.

Economists in the Department are also members of the Irish Government Economic and Evaluation Service (IGEES) which was established in 2012 as an integrated cross-Government service. IGEES aims to support a high and consistent standard of policy evaluation and economic analysis throughout the Civil Service. As members of IGEES, economists in the Department enjoy access to networking events including seminars on issues of common interest, an annual conference and access to training and learning opportunities including in modules provided as part of the Masters in Economics course at UCD.

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.

Please see response to Recommendation 8 in relation to economic seminars.
Also, the Department published four additional analysis papers with the MTFS in 2012. The Department continues to encourage and facilitate the publication of working and research papers by its economists. More recent examples include a technical discussion paper on an economic approach to evaluation the Research and Development (R&D) tax credit, a paper on the impact of the patent cliff on pharm-chem output in Ireland and a working paper that quantified the economic impact of a range of potential structural reforms as well as formal responses to public consultation on Macroprudential Rules and Agri-Food 2025. Lunch and Learns along with Policy Perspective talks by senior managers are open to all staff to attend.

43) The Department should expand its complement of skilled staff in other disciplines, especially accounting, analysis, banking and financial markets.

Please also see response to next question Recommendation 44 below.

In addition to this the Department from 2012 have recruited 58 Administrative Officers (AO's) with specific high level qualifications and experience as listed below:
Economics – 11 AOs (supplemented by a further two senior level economists seconded into the Department from the Pensions Board and the Central Bank)
Finance & Banking – 19 AOs
Tax – 9 AOs
Legal – 11 AOs
Accountancy – 5 AOs
Human Resources – 3 AOs
Further AOs will be recruited from these panels to fill consequential vacancies that arise on foot of internal promotions, and/or natural attrition/movement of existing staff.
In addition to the 11 AOs with qualifications in Economics, among the remainder of the AOs they have qualifications in the following:

- Degree Law
- Degree Management
- Degree Politics
- Degree Public Administration
- Masters Business
- Masters Commerce
- Masters European Studies
- Masters Finance
- Masters HR
- Masters Law
- PHD Economics
- PHD Law

Since 2012 the Department has also made 44 managerial level appointments, 5 at Assistant Secretary, 4 at Principal Officer and 35 at Assistant Principal to further supplement the capability of the Department. In total we have had in the order of 134 new entrants across all grades and over 60 appointments. The following table details the qualifications of staff of the Department:

	Certificate	Diploma/ Higher Diploma	Degree	Masters	PHD	Other	Professional	Total Qualifications
Accounting(47 staff)	15	8	12	4		2	11	52
Business(51 staff)	13	10	25	9		2		59
Finance(41 staff)	13	13	8	8		6	2	50
Legal(34 staff)	3	16	17	4		3	2	45
Economics(70 staff)	7	8	46	39	1	2		103
IT(18 staff)	6	12	5	1			2	26
Other(108 staff)	41	38	55	19	3	4	2	162
Project Management (22 staff)		22						22
Tax(32 staff)		32						32
HR(21 staff)	8	6	3	5		2	1	25
Total Qualifications by award	106	165	171	89	4	21	20	576

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.

The Department is also supplementing skills and numbers in key/critical areas through a number of secondments, on both a paid and pro bono basis from other areas of the civil/public service and private sector - including personnel from the NTMA, the Central Bank, NESC, the Irish Stock Exchange, PWC, Deloitte, KPMG and AIB. Four pro bono staff from the 'Big Four' were also assigned to the Tax area for the duration of the Presidency.

To date the Dept. has seconded in on both a paid and pro bono basis the following number of staff (in total) from both the civil/public service and private sector: Attorney Generals 1, Houses of the Oireachtas 1, Irish Pensions Board 1, Defence Forces 1, Dept. Foreign Affairs & Trade 5, Railway Procurement Agency 2, CSO 2, NESDO 1, NTMA 18, Central Bank 6, Irish Stock Exchange 1, Irish Funds Industry 1, AIB 7, , ,PWC 4, KPMG 2, , KPMG 2, Davy Stockbroker 1, , Deloitte 1, William Fry 1, Mazars 1, A&L Goodbody 1, Dillon Eustace 1 and Matheson 1.

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

Please also see response above. In 2012/21013 the Department made arrangements to temporarily second in four staff (one each) from the Lithuanian, French, UK and German Treasuries. We currently have 13 staff serving in European and International Institutions of which five staff are serving in the Permanent Representation, four staff are Seconded National Experts in the European Commission, two are working in the IMF, one staff member is based in the World Bank and one person working in the German Ministry. Two further staff have returned from assignment in the Greek and Lithuanian finance ministries.

Enhanced HR function:

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.

An experienced HR manager was recruited through an open competition in September 2011 on a 3 year contract and this contract was subsequently extended for a further period of 2 years. The HR Manager is a member of the MAC and his responsibilities are focused primarily on HR matters
The Department's HR transactional and pension's services transferred /outsourced to a Civil Service provided HR Shared Services Environment, PeoplePoint in March 2013 and payroll activity moved to a Payroll Shared Services environment, in September 2014. This has led to a reduction in HR administrative staff within the Division.
HR has developed a HR Strategy 2012-2014 with 5 key elements at its core; Workforce & Succession Planning, Performance Management, Organisational learning & Development, Employee Engagement and Organisational Structure. The Learning and Development Strategy 2014-2016 which sets out the Department's vision on HR and L&D going forward. As part of the strategy Department issued an Employee Engagement survey in 2013, set up employee engagement action teams following the survey who worked together to produce recommendations and actions to senior management on how to manage the results from the 2013 survey. The Employee Engagement survey 2014 has recently been relaunched. This will be followed in mid-2015 with a Civil Service wide survey as part of the Civil Service Reform Initiatives introduced in November 2014 by the Minister for Public Expenditure and

Reform. HR has also set up a Sharepoint site with information available to all staff on Recruitment, Performance Management, Employee Engagement, Learning and Development and HR Administration.

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.

The Department has refocused its performance management process – PMDS - to ensure effective people management processes, and maintain a greater level of compliance and engagement with the process across all levels in the organisation. This is also an integral element of analysing and identifying training and development needs in the Department. There have been a number of comprehensive PMDS training and workshop sessions provided to management and staff, to ensure that individual goals are fully aligned with Divisional Business Planning processes and the high level goals set out in the Department's Statement of Strategy. Guidance Notes for Managers and FAQs were issued to managers in November 2013. Training was provided for all staff in Nov 2013 on 'How to improve the quality of the performance conversation. HR and an external Facilitator facilitated the performance review preparation meetings to provide consistency and a common approach.

See response below.

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.

The PMDS Performance Review process was carried out in the Department in 2012 and 2013 and we achieved a 100% completion rates as against 34% in 2011. In 2013 we invested in training for all staff that focused on improving the quality of the Performance Review conversations. In 2014 we received correspondence from DPER noting our completion rates and progress made in achieving more realistic assessments of the performance of our staff. For 2013 and 2014 we introduced and implemented a Senior Management Performance Review process as a matter of best practice. This process involved a total investment of approximately 2 days by senior management (MAC and PO's) reviewing the performance of their direct reports. The Department looks to nurture the talent of all its staff and along with the development of a Learning and Development Strategy 2014-2016, the Department has focused learning on initiatives to further develop staff to be the 'best we can be'. HR and management have taken a very proactive approach to improving the performance of staff, through the application of project improvement plans, ongoing review, training, referral to CMO where appropriate, mentoring etc. in order to develop and improve performance.

Change Management:

49) The Secretary General should present a Change Management Plan to employees and report on progress in an annual accountability session to all staff.

The revised statement of strategy 2012-2014sets out the goals and objectives for the Department and the transformational elements are being delivered through the Corporate and HR functions. A new Statement of Strategy is being prepared for the period 2015-2017.

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.

The Chief Operations Officer is supported by a team of staff within the Corporate and HR Offices who are tasked with leading on the Department's Transformation Program. The COO is also supported by a number of MAC members.

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Lonergan, Ciara

From:	Lonergan, Ciara
Sent:	30 June 2008 17:15
To:	Beausang, William; Manley, Michael
Cc:	Nolan, Kevin
Subject:	RE: S&P report on Irish banks - see article below, were we able to get a copy of this report previously
Attachments:	S&P reports re irish banks rating 30 June 2007.doc

William/Michael

Please see attached reports from the S&P website - there doesn't seem to be a more detailed report that the first three page one include in the attached.

S&P reports re irish banks rat...

Ciara

From:	Beausang, William
Sent:	30 June 2008 16:33
To:	Manley, Michael; Nolan, Kevin; Lonergan, Ciara
Subject:	S&P report on Irish banks - see article below, were we able to get a copy of this report previously

Credit agency lowers IL&P rating

Monday, 30 June 2008 14:58

Credit rating agency Standard & Poor's has issued a new report on Irish banks in the light of the 'rapidly weakening' Irish economy and depressed Irish and UK property markets.

The agency says the Irish banking system will remain solid, and that while increasing bad loans are a concern, they will not be enough to hit the banks' earnings.

'Medium-term prospects for the Irish banking system remain bright; however, over the... next two years, the weak economy will weigh on performance,' said credit analyst Nigel Greenwood.

Advertisement

S&P renewed its ratings on five of the six banks: AIB, Bank of Ireland, Anglo Irish, IIB Bank and Ulster Bank. But it lowered its rating on Irish Life & Permanent from A to A+, saying its Permanent TSB banking arm had been worse hit than other banks by the disruption in credit markets.

The report also changed the outlook for AIB and Bank of Ireland from positive to stable, meaning it sees an upgrade in their ratings as unlikely in the next couple of years. It also lowered Anglo Irish Bank's outlook from stable to negative, citing its focus on commercial property and warning that a sharp deterioration in the quality of its loans could put pressure on its funding position.

Irish Life & Permanent shares were down 7% at €6.83 in Dublin this afternoon, while Bank of Ireland and Anglo Irish both lost more than 5.5% to €5.52 and €6.14 respectively.

Credit rating agency Standard & Poor's has issued a new report on Irish banks in the light of the 'rapidly weakening' Irish economy and depressed Irish and UK property markets.

The agency says the Irish banking system will remain solid, and that while increasing bad loans are a concern, they will not be enough to hit the banks' earnings.

S&P's reports on Irish banks' rating 30 June 2008

1. *Worsening Economic Environment Leads To Various Rating Actions On Irish Banks Following Review*
2. *Irish Life & Permanent & ILA Ratings Lowered To 'A' On Pressured Bank Operations; Outlook Neg*
3. *Anglo Irish Bank Corp Outlook To Negative On Challenging Environment; 'A/A-1' Ratings Affirmed*
4. *Bank of Ireland Outlook Revised To Stable; 'A+/A-1' Ratings Affirmed*
5. *Allied Irish Banks And AIB UK Outlooks Revised To Stable On Weakening Operating Environment*

1. Worsening Economic Environment Leads To Various Rating Actions On Irish Banks Following Review

LONDON (Standard & Poor's) June 30, 2008--Standard & Poor's Ratings Services said today it has taken various ratings actions on six rated Irish banks (see list below for all banks affected). These actions follow a review of the resilience of Irish bank earnings and asset quality, in particular, to the rapidly weakening Irish economy and depressed property markets in both the Republic and the U.K. (where most of the Irish banks have substantial operations). Rising loan impairments are clearly a concern, but we believe that, for the most part, they will remain insufficient to damage earnings.

"We believe that the Irish banking system will remain solid, being underpinned by good profit margins, clear strategies that are being adjusted to the new operating environment, sound liquidity, and adequate capitalization," said Standard & Poor's credit analyst Nigel Greenwood. We consider risk management across the system to be generally strong, which is appropriate given the rapid credit growth of the past several years and the high property-related bias. "Medium-term prospects for the Irish banking system remain bright; however, over the rating outlook horizon of the next two years, the weak economy will weigh heavily on performance," he added.

As a result of this review, the ratings on five of the six institutions have been affirmed, the exception being the long-term ratings on Irish Life & Permanent PLC (ILP), which have been lowered by one notch to 'A' from 'A+'. The downgrade of ILP reflects the challenged business and financial position in its banking segment, arising from continued disruption in wholesale funding. With a primarily wholesale-funded balance sheet, and a competitive Irish mortgage sector limiting re-pricing, ILP has been worse hit than other Irish banks, most of which have broader business profiles and more balanced funding bases in comparison. The outlook on ILP is negative.

The ratings on the two largest banks, Allied Irish Banks PLC (AIB) and Bank of Ireland (BOI), were affirmed at 'A+', which compares satisfactorily to peer banks with leading domestic franchises in relatively small banking systems. In both cases, we consider that their good business profiles, strong risk management, sound funding and liquidity position, and more adequate capitalization from a low base will support the ratings. We have revised the rating outlook on AIB and BOI to stable from positive because the scope for an upgrade within the outlook timeframe is now unlikely.

We also affirmed the ratings on less-diversified lender Anglo Irish Bank Corp. PLC (Anglo) because we believe that it can demonstrate sufficiently robust asset quality and earnings metrics through the outlook time horizon. As a monoline business with concentration in commercial property-backed lending, and without a core deposit franchise, the margin for error by Anglo's focused management team is small. We consider that a sharp deterioration in asset quality metrics could trigger pressure on the bank's funding position. This, in combination with the increasingly challenging operating environment, has led to a revision of the outlook to negative from stable.

Lastly, we affirmed the ratings on IIB Bank PLC and Ulster Bank Ltd. for whom their respective parent groups are the primary influences under our group rating methodology. In the case of IIB, the ratings are capped at one notch below its parent because we consider it to be a strategically important but noncore subsidiary of KBC

Bank N.V. (AA-/Stable/A-1+), which is manifested in a three-notch uplift to IIB's stand-alone assessment. IIB's market position is relatively modest.

With regard to Ulster Bank Ltd., which is incorporated in the U.K., but the majority of loan assets and earnings are derived from the Republic of Ireland (with the balance coming from Northern Ireland), we consider Ulster to be a core subsidiary of The Royal Bank of Scotland Group PLC (the main operating bank is rated AA/Negative/A-1+). Therefore, the ratings on Ulster benefit from a three-notch uplift and are equalized with the ratings on Royal Bank of Scotland PLC. We view Ulster's business profile as the next strongest after AIB and BOI, but consider that its relatively aggressive growth has left its financial profile a little less well positioned.

The current review has taken place in the midst of a rapidly changing economy. Irish banks have benefited from the very strong Irish growth over the past several years. Since the mid 1990s, Ireland has been the best performing economy in Western Europe. Ireland's wealth, at an estimated GDP per capita of $67,000 in 2008, exceeds the 'AAA' median, estimated at $51,000 in the same period. Irish real GDP growth in 2007 was a healthy 5.3% and the five-year average to 2007 was 5.2%.

The Irish economy is slowing rapidly, however. In 2008, Standard & Poor's now forecasts real GDP growth of just 0.5% with a partial recovery to 1.5% in 2009. This is a sharp decline. Three manifestations of this decline are house prices, credit growth, and house completions. Irish house prices peaked in early 2007 and are now, on average, about 10% lower. Residential mortgage credit growth was running at a high annualized 20%-25% through 2005, 2006, and into 2007, but has since rapidly trended down month by month to about 10%. A particular issue pertinent to Ireland is the rapid decline in house completions. From a peak of 90,000 units in 2006, this amount will be barely more than one-half of that level in 2008.

Similar to U.K. peers, who face not dissimilar issues, Irish banks have been reducing their risk appetite, partly in the face of more expensive and restricted funding. Our rating actions also take into account their operations in the U.K. These are material for AIB (mainly business banking), Anglo (property lending), BOI (mainly business banking and residential mortgage lending), and--to a lesser extent--ILP (mainly buy-to-let mortgages). Standard & Poor's has also revised downward its forecast for U.K. real GDP growth to 1.5% in 2008 and to 1.3% in 2009.

Asset quality concerns are mainly twofold. First, Irish banks have large exposures to property and construction lending relative to peers. There is already some evidence that these loans, particularly those to small residential property developers in Ireland, are deteriorating as the economy slows. Second, their mortgage books are weighted toward recent higher loan-to-value lending, particularly the 2006 and 2007 vintages--a period when competitive pressures forced lending standards to be relaxed. Compared with the mortgage books of U.K. peers, buy-to-let lending has a higher weighting in Irish mortgage books, but--fortunately--Irish subprime mortgages did not take off in time and there is no specific equivalent of the self-certified mortgage.

If these asset quality concerns emerge further and if the Irish and U.K. economic downturn is more severe than expected, then the ratings will be under additional negative pressure.

RATINGS LIST
Ratings Affirmed

IIB Bank PLC
Counterparty credit rating A+/Stable/A-1

Ulster Bank Ltd.
Ulster Bank Ireland Ltd.
Counterparty credit rating AA/Negative/A-1+

Ratings Lowered

	To	From
Irish Life & Permanent PLC		
Counterparty credit rating		
	A/Negative/A-1	A+/Negative/A-1

Outlook Revised

	To	From
Allied Irish Banks PLC		
Counterparty credit rating		
	A+/Stable/A-1	A+/Positive/A-1
Anglo Irish Bank Corp. PLC		
Counterparty credit rating		
	A/Negative/A-1	A/Stable/A-1
Bank of Ireland		
Counterparty credit rating		
	A+/Stable/A-1	A+/Positive/A-1

NB: This list does not include all ratings affected.

2. Irish Life & Permanent & ILA Ratings Lowered To 'A' On Pressured Bank Operations; Outlook Neg

LONDON (Standard & Poor's) June 30, 2008--Standard & Poor's Ratings Services said today that it lowered its long-term counterparty credit rating on Irish Life & Permanent PLC (ILP) to 'A' from 'A+'. At the same time, the 'A-1' short-term counterparty credit rating was affirmed. Furthermore, the long-term counterparty credit and insurer financial strength ratings on Irish Life Assurance PLC (ILA), a core operating subsidiary of ILP, were also lowered to 'A' from 'A+'. The outlooks on both entities remain negative.

"The downgrade reflects ILP's challenged business and financial position in its banking division, arising from continued disruption in wholesale funding. With a primarily wholesale-funded balance sheet, and a competitive Irish mortgage sector constraining re-pricing, ILP has been affected more than other Irish banks, most of which have broader business profiles and more balanced funding bases in comparison," said Standard & Poor's credit analyst Claire Curtin.

We have kept the outlook as negative because of our expectation of significant deterioration in profitability from ILP's banking operations in 2008, excluding the positive impact of one-off items, from a pressured net interest margin. Ongoing increased funding costs and low business volumes may have a material impact on profitability in future years. The maturity profile of ILP's wholesale funding is considerably shorter than at year-end 2007, a trend which is not expected to significantly reverse in the near term. Loan impairments are currently manageable, but could become cause for concern

The relatively short average maturity of ILP's wholesale funding results in a significant refinancing burden. To date, it has managed this quite well, through a mix of secured and unsecured sources. The bank currently has substantial outstandings with the European Central Bank (ECB), resulting in a relatively high proportion of secured funding within its funding base. ECB drawings are expected to decline somewhat upon establishment of market secured funding facilities, but we expect ECB usage to remain high relative to peers.

Funding constraints have significantly moderated ILP's appetite for new business. While we view this as preferable to funding loan growth through ECB secured lending facilities, we view it as limiting ILP's ability to compete in the Irish retail lending market, where it has been the leading lender for several years. It has the potential to interrupt ILP's ambitious banking growth strategy in Ireland, which has the ultimate objective of being the largest retail bank in Ireland.

"The negative outlook reflects the continuing constraints on ILP's banking operations, the bank's restricted access to funding and the increasing encumbrance of the balance sheet, the potential damage to ILP's ambitions in Irish retail banking of such constraints, and the expectation that profitability will remain materially diminished beyond 2008," added Ms. Curtin.

The ratings incorporate our expectations that asset quality will remain satisfactory and that liquidity is good given the stock of eligible assets on ILP's balance sheet.

The ratings could be lowered if the funding profile does not improve, current business constraints affect ILP's competitive position in Irish retail banking, or if profitability is materially affected beyond 2008 by higher funding costs. A significant deterioration in asset quality could also result in a downgrade, although we do not expect asset quality to pressure the rating in 2008.

The outlook could be revised to stable if ILP manages to re-engineer its funding profile without materially affecting ongoing profitability.

3. Anglo Irish Bank Corp Outlook To Negative On Challenging Environment; 'A/A-1' Ratings Affirmed

LONDON (Standard & Poor's) June 30, 2008--Standard & Poor's Ratings Services said today it revised its outlook on Anglo Irish Bank Corp. PLC (Anglo) to negative from stable. At the same time, the 'A/A-1' counterparty credit ratings on Anglo were affirmed.

"The outlook revision has been triggered by the accelerating economic slowdown and an increasingly challenging operating environment," said Standard & Poor's credit analyst Claire Curtin. As a monoline business with concentration in commercial property-backed lending, and without a core deposit franchise, Anglo is more exposed than its higher rated peers to a precipitous deterioration in the economy.

"The ratings on Anglo reflect its highly efficient business model, robust profitability, high level of internal capital generation, and prudent liquidity policy," said Ms. Curtin.

The rating affirmation reflects our expectation that Anglo's business model and underwriting process will allow it to continue to outperform in terms of credit quality and losses. However, the margin for error for Anglo's adroit management team is small and the focus of Anglo's operations on property and construction (P&C) lending leaves it particularly vulnerable to a prolonged downturn and resultant high loan losses.

Anglo's deposit franchise has been resilient in testing conditions. We consider that the profile of its deposit base is potentially sensitive to a sharp deterioration in asset quality metrics. We view corporate and retail term deposits as less sticky than a core current account franchise, and a point of potential rating vulnerability.

Going some way to offset these potential weaknesses is Anglo's robust profitability--pretax profits were 3.2% of average risk assets in 2007, a level significantly in excess of peers. Profitability is boosted by the bank's highly efficient business model, which should provide some protection against our expectations of increased loan losses. Also, Anglo's internal capital generation is high, due to its low dividend payout ratio. Capitalization ratios by Standard & Poor's measures have recently displayed material improvement as a consequence. We expect capital policies to remain focused on internal capital generation and retention.

"We consider that there is a one-in-three chance or greater that Anglo's asset quality will materially diverge from our expectations," said Ms. Curtin. "A sharp deterioration in credit risk metrics would likely trigger increased pressure on the bank's funding position. We expect Anglo's earnings to remain robust, and capitalization to continue on its improving trend," she added.

The outlook would be revised back to stable should Anglo continue to outperform its peers in terms of credit losses through this turn of the credit cycle, and demonstrate its superior underwriting capabilities and robust deposit franchise.

The ratings on Anglo would be lowered if the strength of its deposit base weakened, or if significant credit losses were to emerge.

4. Bank of Ireland Outlook Revised To Stable; 'A+/A-1' Ratings Affirmed

LONDON (Standard & Poor's) June 30, 2008--Standard & Poor's Ratings Services said today that it revised its outlook on Bank of Ireland (the trading name of The Governor and Company of the Bank of Ireland; BOI) to stable from positive. In addition, the 'A+/A-1' long- and short-term counterparty credit ratings were affirmed.

"The outlook revision follows a review of the ratings on Irish banks and reflects weaker near-term earnings prospects for BOI arising from the deterioration in the economic and market environment in Ireland and the U.K., which renders the likelihood of an upgrade in the near term remote," said Standard & Poor's credit analyst Giles Edwards.

The ratings on BOI continue to reflect its strong market position in Ireland, good business diversity, and sound track record. Capitalization remains relatively weak, but has been improving. BOI has shown solid progress in the past couple of years in improving efficiency and expanding the franchise and earnings contribution of its businesses outside of Ireland. Both should leave it better placed to withstand a tougher environment. BOI's earnings are likely to be challenged by the continued higher funding costs and credit loss provisions that are rising from cyclical lows. The bank expects its bad-debt charge to rise from a low 17 basis points in the year to March 31, 2008, to about 25 basis points this year. While there is clear downside risk from the property-related elements of BOI's loan portfolio, asset quality remains very good across all of BOI's activities, helped by a strong risk management culture, and is expected to remain manageable through this cyclical downturn.

"The stable outlook reflects Standard & Poor's view that BOI's strong domestic franchise, good long-term prospects for the Irish economy, and the bank's credible multi-niche strategy overseas offer it a bright future," added Mr. Edwards.

BOI's credit risk profile presents the potential for performance pressures in the coming 18 months, but we expect the bank to remain solidly profitable through the downturn, despite increased credit costs.

Positive rating action could result if BOI's performance through the downturn exceeds our expectations. In particular, we are looking for continued sound revenue growth and franchise strengthening in the non-Irish businesses, and relative asset-quality measures to remain better than peers. Continued improvement in the bank's capitalization and funding profile would also strengthen the case for an upgrade.

Negative rating action would most likely be prompted by a severe deterioration in asset quality, which materially impaired earnings. Other drivers would include a weakening of funding profile and/or capitalization

5. Allied Irish Banks And AIB UK Outlooks Revised To Stable On Weakening Operating Environment

LONDON (Standard & Poor's) June 30, 2008--Standard & Poor's Ratings Services said today that it revised its outlook on Allied Irish Banks PLC (AIB), and AIB Group (UK) PLC (AIB UK) to stable from positive. At the same time, the 'A+/A-1' long- and short-term counterparty credit ratings on both entities were affirmed. We consider AIB UK to be a core subsidiary of the AIB group and therefore the rating on AIB UK mirrors that of its parent.

"The ratings on AIB reflect the bank's strong position in the Irish banking sector, improved capitalization, and sound funding and liquidity position," said Standard & Poor's credit analyst Claire Curtin.

"The outlook revision to stable from positive reflects a more pessimistic assessment of the expected progression of AIB's property-backed commercial (P&C) loan portfolio now that the economic slowdown has accelerated," added Ms. Curtin.

We consider the bank to be overweight in P&C lending--36% of AIB's loan portfolio at Dec. 31, 2007--particularly in the development segment. Exposure has grown rapidly in both absolute terms and relative to the rest of the loan book over the past few years. Of the P&C book, about 47% relates to development lending, while 50% relates to property investment lending. The P&C book is split 55% in Ireland, and 36% in the U.K.

The stable outlook reflects AIB's sound position in the Irish banking sector, solid funding and liquidity position, improved capitalization, and our expectation of increasing pressures on profitability from the P&C loan book as losses emerge. We expect the bank to remain comfortably profitable.

Positive rating action could result should AIB's performance over the next two years exceed our expectations, through demonstration of resilient profitability and asset quality through the expected more challenging operating conditions.

Negative rating action would occur from a severe deterioration in asset quality which materially impaired earnings, or due to aggressive expansion into new markets.

Irish economy mirrors Asia's before the bust

Fri, Jan 16, 1998

The very disturbing aspect of the Asian crisis which is still threatening to engulf the entire global financial system is that it has got almost nothing to do with economics and everything to do with simple property and stock booms.

The Asian story is simply one of boom and bust stemming from bad investment and lending. Financial implosion in countries such as Indonesia, South Korea and Thailand has resulted from a lethal combination of overlending, too much investment in the wrong things and to cap it all, a rather ridiculous weakness for believing your own propaganda which in itself caused investors to look at only the most rosy scenarios for returns when placing their bets.

It is essential to remember that the Asian economies collapsed at a time when traditional measures of performance such as unemployment levels, government borrowing, budget deficits and inflation were at historically low levels, while growth rates in all economies were roaring away at above 5 per cent.

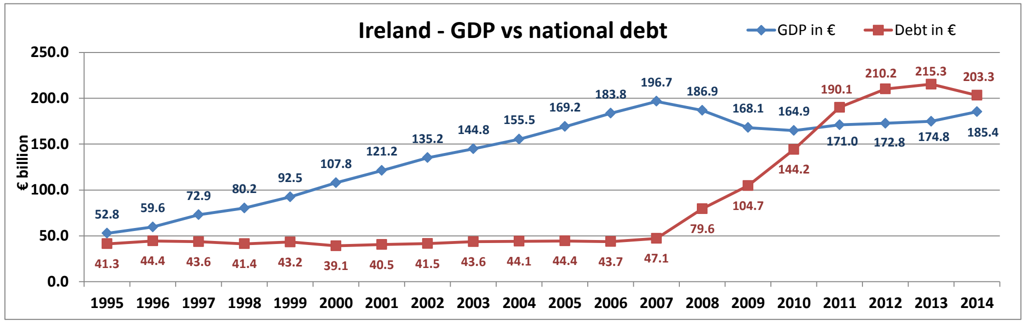
The first thing to appreciate is that the background noise was all positive. Thus, politicians could bang on about enviable "fundamentals" while failing to see the wood from the trees. Economic numbers gradually became a sort of meaningless mantra, a thin veneer under which a property-price bubble grew and grew. Innocently, sanguine domestic punters borrowed up to the hilt at low interest rates to finance speculation in property and

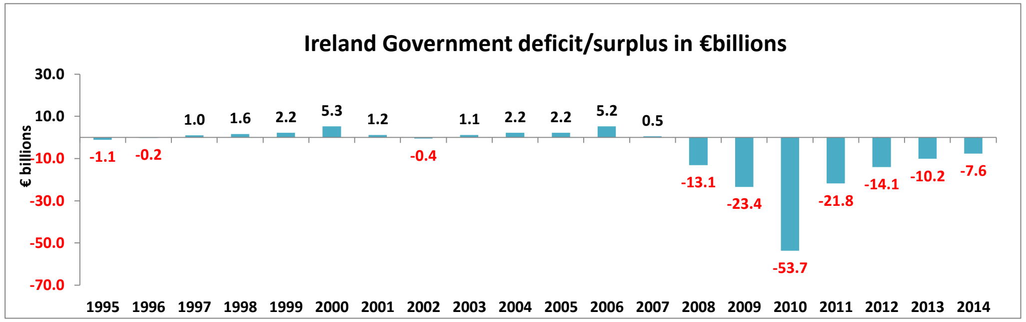
other assets, falsely secure in the knowledge that with these so-called fundamentals, everything was fine and dandy. Fundamentals how are you!

It is this apparent contradiction between glittering macroeconomic numbers and a meltdown in asset prices which makes the sorry tale an extremely cautionary and pertinent one for our own economy.

The first lesson for Ireland is that previously sacrosanct numbers such as the budget deficit, the debt/GDP ratio or the trade surplus, although valuable in certain contexts (like qualification for EMU for example), are in effect yesterday's acid tests. "Yesterday's" in the sense that their sell-by date as barometers of the health of the economy is well past us. If you have a persistent budget, government debt or trade

Source: http://ec.europa.eu/eurostat/web/national-accounts/data/database





Ireland

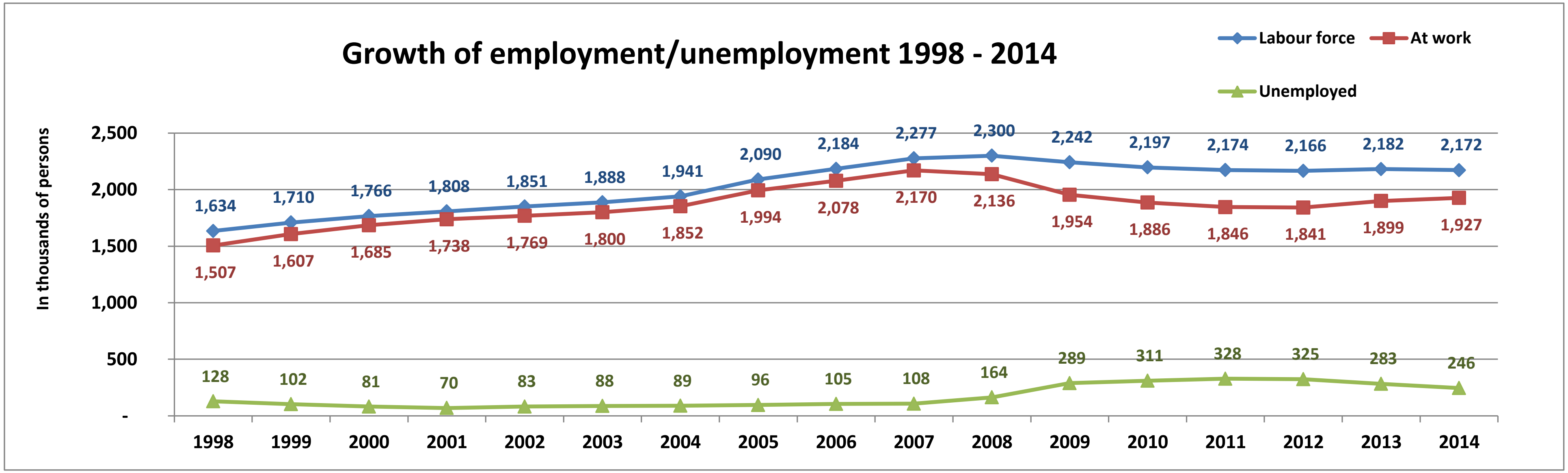
	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
GDP in €	52,828.5	59,626.7	72,940.6	80,218.2	92,491.1	107,799.3	121,198.7	135,179.1	144,839.8	155,470.2
Debt in €	41,333.3	44,446.7	43,599.1	41,352.7	43,212.9	39,094.1	40,524.2	41,538.5	43,555.9	44,055.8
General government gross debt to GDP	78.7	70.0	61.7	51.6	46.7	36.3	33.4	30.7	30.1	28.3
Government deficit/surplus in %GDP	-2.1	-0.3	1.3	2.0	2.4	4.9	1.0	-0.3	0.8	1.4
Government deficit/surplus in €	-1,134.2	-153.0	969.0	1,630.6	2,239.5	5,278.6	1,181.6	-436.8	1,090.3	2,169.6
Revenues in %GDP	38.8	38.8	37.9	36.7	36.4	35.9	33.7	32.9	33.9	34.7
Revenues in € (approx)	20,497	23,135	27,644	29,440	33,667	38,700	40,844	44,474	49,101	53,948
Expenditure in %GDP	40.9	39.1	36.6	34.7	34.0	31.0	32.7	33.2	33.1	33.3
Expenditures in € (approx)	21,607	23,314	26,696	27,836	31,447	33,418	39,632	44,879	47,942	51,772
Net lending or borrowing in %GDP	-2.1	-0.3	1.3	2.0	2.4	4.9	1.0	-0.3	0.8	1.4

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
GDP in €	169,152.9	183,759.2	196,748.5	186,870.2	168,114.0	164,928.4	171,042.3	172,754.7	174,791.3	185,411.7
Debt in €	44,379.3	43,692.3	47,147.8	79,604.7	104,667.4	144,227.1	190,122.6	210,238.1	215,327.7	203,319.4
General government gross debt to GDP	26.2	23.8	24.0	42.6	62.3	87.4	111.2	121.7	123.2	109.7
Government deficit/surplus in %GDP	1.3	2.8	0.3	-7.0	-13.9	-32.5	-12.7	-8.1	-5.8	-4.1
Government deficit/surplus in €	2,181.3	5,194.8	535.8	-13,103.5	-23,440.2	-53,677.2	-21,803.7	-14,065.0	-10,152.4	-7,629.2
Revenues in %GDP	34.8	36.9	36.2	35.0	33.7	33.6	33.6	34.2	34.9	34.9
Revenues in € (approx)	58,865	67,807	71,223	65,405	56,654	55,416	57,470	59,082	61,002	64,709
Expenditure in %GDP	33.5	34.1	35.9	42.0	47.6	66.1	46.3	42.3	40.7	39.0
Expenditures in € (approx)	56,666	62,662	70,633	78,485	80,022	109,018	79,193	73,075	71,140	72,311
Net lending or borrowing in %GDP	1.3	2.8	0.3	-7.0	-13.9	-32.5	-12.7	-8.1	-5.8	-4.1

Quarter 2 of each year

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Labour force	1,634	1,710	1,766	1,808	1,851	1,888	1,941	2,090	2,184	2,277	2,300	2,242	2,197	2,174	2,166	2,182	2,172
At work	1,507	1,607	1,685	1,738	1,769	1,800	1,852	1,994	2,078	2,170	2,136	1,954	1,886	1,846	1,841	1,899	1,927
Unemployed	128	102	81	70	83	88	89	96	105	108	164	289	311	328	325	283	246
Unemployed %	7.8%	6.0%	4.6%	3.9%	4.5%	4.6%	4.6%	4.6%	4.8%	4.7%	7.1%	12.9%	14.1%	15.1%	15.0%	13.0%	11.3%

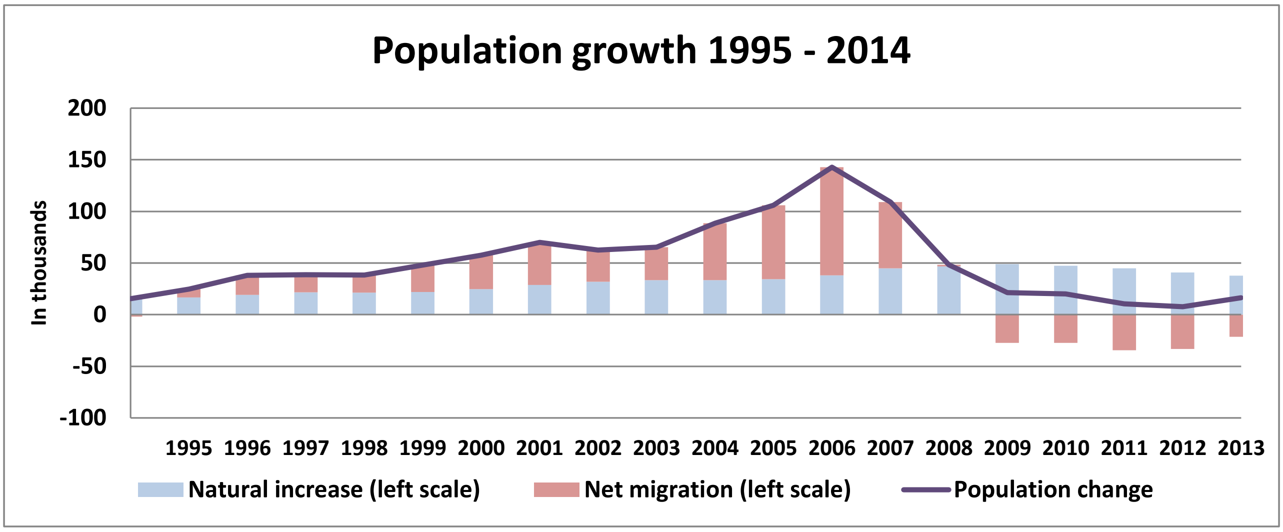
See CSO / StatBank Table QNQ24

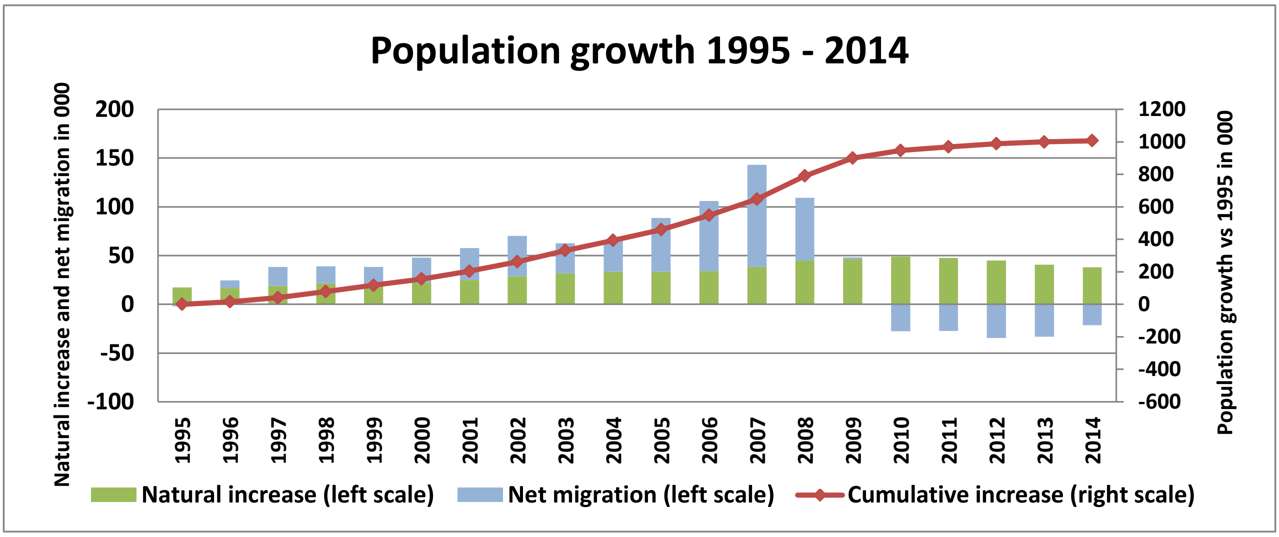


CSO figures: http://www.cso.ie/multiquicktables/quickTables.aspx?id=pea15

Components of Population change

Year ending April	Births	Deaths	Natural increase (left scale)	Immigrants	Emigrants	Net migration (left scale)	Population change	Cumulative increase (right scale)	Population
1995	48.4	31.2	17.2	31.2	33.1	-1.9	15.4	0	3,601.30
1996	48.8	32	16.7	39.2	31.2	8	24.8	15.4	3,626.10
1997	50.7	31.7	19	44.5	25.3	19.2	38.2	40.2	3,664.30
1998	52.7	31.2	21.5	46	28.6	17.4	38.8	78.4	3,703.10
1999	53.7	32.4	21.2	48.9	31.5	17.3	38.5	117.2	3,741.60
2000	54	32.1	21.8	52.6	26.6	26	47.9	155.7	3,789.50
2001	55.1	30.2	24.8	59	26.2	32.8	57.7	203.6	3,847.20
2002	58.1	29.3	28.8	66.9	25.6	41.3	70	261.3	3,917.20
2003	60.8	28.9	31.9	60	29.3	30.7	62.6	331.3	3,979.90
2004	62	28.6	33.3	58.5	26.5	32	65.3	394	4,045.20
2005	61.4	27.9	33.5	84.6	29.4	55.1	88.6	459.3	4,133.80
2006	61.2	27	34.2	107.8	36	71.8	106	547.9	4,232.90
2007	66.6	28.4	38.2	151.1	46.3	104.8	142.9	647	4,375.80
2008	73	28	44.9	113.5	49.2	64.3	109.2	789.9	4,485.10
2009	75.3	28.6	46.7	73.7	72	1.6	48.3	899.2	4,533.40
2010	77.2	28.4	48.8	41.8	69.2	-27.5	21.4	947.5	4,554.80
2011	75.1	27.7	47.5	53.3	80.6	-27.4	20.1	968.9	4,574.90
2012	74	29.2	44.9	52.7	87.1	-34.4	10.5	989	4,585.40
2013	70.5	29.7	40.8	55.9	89	-33.1	7.7	999.5	4,593.10
2014	67.7	29.8	37.9	60.6	81.9	-21.4	16.5	1,007.20	4,609.60
	1246.3	**592.3**	**653.6**	**1301.8**	**924.6**	**376.6**	**1030.4**		





The Bulletin makes the following key points:

- **The muted pick up in economic activity since Autumn 2001 points to GNP to growth of 3 per cent this year.** This GNP forecast is the same as the Department's ERO forecast and the Bank's forecast for 2002 GDP is 4 per cent compared to the Department's ERO forecast of 3.6 per cent. The qualitative industrial confidence indicators are generally weak and consumer expenditure remains sluggish. For 2003 the picture is one of a high degree of uncertainty. **There may be a modest acceleration in real GNP growth next year to around 4¼ per cent.**

- **Export growth to remain weak.** There are reasons for caution as regards the outlook for exports. The current international background for the Irish economy is one of weak growth. The international recovery shows signs of proceeding at a slower pace, and rising domestic costs combined with a stronger euro have affected the competitiveness position. The strength of recent export data is due to very strong output growth in one sector – chemicals and related products.

- **Employment growth to moderate….** Service sector employment is likely to moderate given sluggish consumer spending and the need to limit public sector expenditure. Overall employment is set to grow by 22,000 (1.3 per cent this year). Next year employment growth of around 23,000 is forecast by the Bank.

- **….and Unemployment to rise.** Given the moderation in employment growth, unemployment is set to increase to average about 4½ per cent this year. An increase in the unemployment rate to around 5 per cent next year is being forecast.

- **Inflation to remain above euro area average.** Inflation as measured by the CPI is expected to average 4½ per cent for the year as a whole. The main factors underlying the trend are the impact of recently announced increases in a range of regulated services and negative base effects.

- **Competitiveness position deteriorates.** Wage inflation remains well in excess of rates prevailing in our main trading partners. While strong productivity growth in the manufacturing sector ensured a slight improvement in competitiveness last year, when the exceptional output growth in the chemical sector is excluded, there was a clear loss of competitiveness in the remaining sectors. This deteriorating trend looks set to continue this year and next.

c.c Secretary General, E. O'Sullivan, D. Doyle, N. O'Gorman, C. O'Loghlin.

Minister from Dermot Mulligan
20th November 2002

OECD Autumn 2002 Economic Forecasts

The OECD will publish their autumn forecasts on Thursday morning, 21st November. The OECD stress that:

- **The government needs to act quickly to bring the rapid growth of public consumption and employment under control so as to maintain needed improvements to infrastructure without increasing the budget deficit.**

- **Benchmarking should only be granted against commitments to improve work practices.**

- **There is no room for another national wage agreement based on tax cuts.**

- **If wage growth fails to decelerate, there will be a further loss of competitiveness and slower economic growth.**

The key points from the OECD's forecasts are summarised below:

Ireland: Key Projections

- Despite a strong rebound in growth in the first half of the year, real GDP is expected to grow by just 3.6 per cent in both 2002 and 2003 (for 2003 both the EU Commission and the ESRI projected 4.2 per cent). Real GNP is forecast to grow by 2.8 per cent and 2.5 per cent respectively. The strong first half growth was underpinned by a surge in public consumption and strong exports, both of which are expected to fade.

- GDP is forecast to expand by 4.4 per cent in 2004 (real GNP growth of 3.3 per cent), supported by private consumption and a recovery of investment. However if wage growth fails to decelerate there would be a further loss to competitiveness and slower growth.

- Inflation, as measured by the HICP, is forecast to follow a downward trend, averaging 4.7 per cent this year, 4.3 per cent in 2003 and 3.8 per cent in 2004.

- The General Government balance is expected to record a deficit of –0.5 per cent of GDP this year, with the situation worsening to –1.3 per cent in 2003 and –1.8 per cent in 2004. These projections assume that Benchmarking will begin to be paid next year. This swing from surplus to deficit only partly reflects the cyclical slowdown, and probably also reflects underestimation of the cost of income tax cuts.

- Unemployment is expected to average 4.4 per cent in 2002, 5.1 per cent in 2003 and 5.3 per cent in 2004.

Table 1 below summarises the forecasts projections.

	2002	2003	2004
Gross Domestic Product	3.6	3.6	4.4
Gross National Product	2.8	2.5	3.3
Inflation (HICP)	4.7	4.3	3.8
Unemployment Rate	4.4	5.1	5.3
General Government deficit	-0.5	-1.3	-1.8

International Economy: Key Projections

- In the euro area, real GDP is expected to grow by 0.8 per cent and 1.8 per cent this year and next respectively. By 2004 the full effects of the international recovery will have taken hold and this is reflected in a GDP growth figure of 2.8 per cent. Growth of 0.9 per cent is forecast for the EU this year, followed by growth rates of 1.9 per cent in 2003 and 2.7 per cent in 2004.

- Growth in the US is also expected to recover. Real GDP is expected to grow by 2.3 per cent in 2002, 2.6 per cent next year, and 3.6 per cent in 2004. Real GDP is expected to contract for the second consecutive year in Japan in 2002, falling by 0.7 per cent. However positive growth rates are then expected to resume, with GDP expanding by 0.8 per cent in 2003 and 0.9 per cent in 2004.

- Over the medium term, euro area inflation is expected to trend to the ECB's self imposed limit of 2 per cent. As measured by the harmonised index of consumer prices, inflation is expected to average 2.4 per cent this year, 2.2 per cent in 2003 and 2.0 per cent in 2004.

c.c Secretary General, E. O'Sullivan, D. McNally, D. Doyle, N. O'Gorman, C. O'Loghlin, Press Office.

Dataset: Details of Tax Revenue - Ireland

Source: https://stats.oecd.org/Index.aspx?DataSetCode=REV

		Government														
		Unit														
		Year	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Tax																
Total tax revenue			**13,836**	**14,451**	**16,183**	**18,502**	**21,289**	**24,666**	**28,681**	**29,615**	**31,367**	**34,444**	**38,466**	**42,310**	**48,630**	**50,472**	**43,747**
Total tax revenue	Total tax revenue exclusive of custom duties		..	..	..	..	..	..	..	..	..	..	..	..	..	..	..
1000 Taxes on income, profits and capital gains			**6,901**	**7,022**	**8,006**	**9,225**	**10,511**	**12,440**	**14,564**	**14,984**	**15,188**	**16,683**	**18,611**	**20,084**	**23,549**	**24,525**	**21,149**
1100 Of individuals			5,453	5,563	6,192	7,070	7,896	8,998	10,650	10,814	10,370	11,518	13,265	14,568	16,850	18,127	16,066
1110 On income and profits			5,393	5,507	6,086	6,902	7,651	8,546	9,876	9,939	9,751	10,082	11,737	12,586	13,750	15,029	14,642
1110 On income and profits	Income tax		5,393	5,507	6,086	6,902	7,651	8,546	9,876	9,939	9,751	10,082	11,737	12,586	13,750	**15,029**	14,642
	IN % of total tax revenue		39%	38%	38%	37%	36%	35%	34%	34%	31%	29%	31%	30%	28%	30%	33%
1120 On capital gains			60	56	106	168	245	452	774	876	619	1,436	1,528	1,982	**3,099**	**3,097**	1,424
1200 Corporate			1,448	1,458	1,813	2,155	2,614	3,442	3,899	4,154	4,810	5,160	5,340	5,510	6,687	6,393	5,073
1210 On profits	Corporation tax		1,448	1,458	1,813	2,155	2,614	3,442	3,885	4,144	4,804	5,155	5,335	5,503	**6,685**	6,393	5,071
1300 Unallocable between 1100 and 1200			-	-	-	-	-	-	16	16	8	5	5	5	12	5	10
3000 Taxes on payroll and workforce			**275**	**209**	**210**	**241**	**284**	**97**	**15**	**203**	**241**	**255**	**282**	**332**	**368**	**411**	**414**
4000 Taxes on property			**353**	**370**	**474**	**599**	**766**	**1,030**	**1,258**	**1,324**	**1,256**	**1,738**	**2,221**	**2,722**	**3,892**	**3,530**	**2,037**
4100 Recurrent taxes on immovable property			18	15	18	4	2	2	-	-	-	-	-	0	- 0	0	-
4220 Corporate			..	..	..	..	..	..	..	..	..	..	..	..	..	..	..
4300 Estate, inheritance and gift taxes			75	76	104	113	142	192	225	169	152	214	190	255	316	405	349
4310 Estate and inheritance taxes			71	73	93	106	134	179	210	156	139	187	176	207	283	337	302
4320 Gift taxes			4	3	11	6	8	13	15	14	13	27	14	48	32	68	47
4400 Taxes on financial and capital transactions			260	279	352	482	622	836	1,033	1,154	1,104	1,525	2,030	2,467	3,576	3,124	1,688
4400 Taxes on financial and capital transactions	Stamp duty		260	279	352	482	622	836	1,033	1,154	1,104	1,525	2,030	2,467	**3,576**	3,124	1,688
5000 Taxes on goods and services			**6,222**	**6,763**	**7,402**	**8,336**	**9,621**	**10,984**	**12,722**	**12,965**	**14,532**	**15,607**	**17,168**	**18,954**	**20,580**	**21,744**	**19,873**
5100 Taxes on production, sale, transfer, etc			5,896	6,419	7,043	7,942	9,195	10,473	12,167	12,322	13,854	14,815	16,315	18,043	19,591	20,644	18,627
5110 General taxes			3,308	3,666	4,101	4,711	5,589	6,401	7,643	7,996	9,134	9,808	10,986	12,373	13,746	14,355	13,084
5111 Value added taxes			3,308	3,666	4,101	4,711	5,589	6,401	7,643	7,996	9,134	9,808	10,986	12,373	13,746	14,355	13,084
5111 Value added taxes	Value added tax		3,308	3,666	4,101	4,711	5,589	6,401	7,643	7,996	9,134	9,808	10,986	12,373	13,746	**14,355**	13,084
5120 Taxes on specific goods and services			2,588	2,753	2,943	3,231	3,606	4,072	4,525	4,326	4,720	5,007	5,329	5,669	5,845	6,289	5,542
5121 Excises			2,440	2,608	2,839	3,107	3,487	3,923	4,407	4,188	4,568	4,723	5,043	5,377	5,659	6,103	5,367
5121 Excises	Beer		396	410	433	449	478	478	475	475	473	461	457	457	457	459	431
	Oils		876	919	1,009	1,137	1,306	1,435	1,491	1,404	1,641	1,730	1,975	2,073	2,151	2,204	2,168
	Spirits		163	160	175	183	187	218	241	254	269	308	315	322	338	363	337
	Tobacco		586	668	677	727	781	863	1,035	1,066	1,137	1,157	1,059	1,079	1,104	1,192	1,171
	Wine, cider, perry		71	79	93	103	120	140	154	177	218	228	252	262	278	297	290
	Motor vehicle (incl. tyres)		344	367	449	503	611	785	985	787	802	809	956	1,153	1,301	**1,554**	938
	Others		4	4	4	5	3	5	25	26	28	31	31	31	30	34	32
5126 Taxes on specific services			141	134	123	116	130	143	118	138	152	284	286	292	186	186	175
5126 Taxes on specific services	Duty on betting		46	49	52	58	66	67	59	69	45	39	46	53	51	36	35
	Bank levy		46	30	15	-	-	-	-	-	-	103	103	103	-	-	-
	Other		49	55	57	58	63	76	59	69	107	142	137	136	135	150	140
5200 Taxes on use of goods and perform activities			326	344	358	393	426	511	555	643	678	792	853	912	989	1,100	1,246
5210 Recurrent taxes			326	344	358	393	426	511	555	643	678	792	853	912	989	1,100	1,246
5211 Paid by households: motor vehicles			163	173	178	195	211	259	373	419	441	515	566	607	665	723	800
5212 Paid by others: motor vehicles			133	142	145	160	173	212	124	137	145	170	187	201	220	239	265
5213 Paid in respect of other goods			30	29	35	38	42	40	58	87	92	107	101	104	104	138	182
6000 Other taxes			-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
6200 Other			..	..	..	..	..	..	..	..	..	..	..	..	..	..	..
Total tax revenue on cash basis			13,836	14,451	16,183	18,502	21,004	24,520	28,394	29,578	31,039	34,255	38,082	41,896	48,306	50,519	44,340
Total tax revenue on accrual basis			..	..	..	..	21,289	24,666	28,681	29,615	31,367	34,444	38,466	42,310	48,630	50,472	43,747
Additional taxes included in National Accounts			..	..	..	..	-	-	-	-	-	-	-	-	-	-	-
National Accounts: Taxes and actual social contributions			..	..	..	..	21,289	24,666	28,681	29,615	31,367	34,444	38,466	42,310	48,630	50,472	43,747
Imputed social contributions			..	..	..	..	-	-	863	913	1,026	1,121	1,222	1,926	2,094	2,231	2,284
National Accounts: Taxes and all social contributions			..	..	..	..	21,289	24,666	29,544	30,528	32,393	35,565	39,688	44,235	50,724	52,703	46,031

http://www.budget.gov.ie/Budgets/2003/Summary.aspx

BUDGET 2003 / Extract

CERTAIN CAPITAL ALLOWANCES AND TAX INCENTIVE SCHEMES

Tax Incentive Schemes The table below sets out the termination dates for a range of tax incentive schemes in the property and film sectors. It has been decided that the termination date for all of these schemes is to be set at 31 December 2004. No further time extensions will be made to these schemes and therefore the termination dates provided represent the final dates for incurring qualifying expenditure under the schemes except in the case of buildings in use for third level purposes where the termination date described below represents the final date for the issue of Ministerial Certificates of approval. Schemes where some alteration is being made to existing qualifying dates are marked (*) and the relevant details are provided below:

Scheme	**Termination date**
Urban Renewal Scheme*	31 December 2004
Rural Renewal Scheme	31 December 2004
Town Renewal Scheme*	31 December 2004
Living Over the Shop Scheme	31 December 2004
Multi-storey car parks Scheme	31 December 2004
Park and Ride Scheme*	31 December 2004
Student Accommodation Scheme*	31 December 2004
Buildings used for third level purposes	31 December 2004
Film Relief Scheme*	31 December 2004

In relation to the Urban Renewal Scheme, the final date for incurring 15% of the total project costs is being extended from 31 December 2002 to 30 June 2003. There is no change to the final date for incurring qualifying expenditure under the scheme. That date will remain, as set out in the table above, at 31 December 2004.

The termination date for the qualifying period for the Town Renewal Scheme in respect of tax relief on expenditure on commercial, industrial and residential projects is being extended by one year from 31 December 2003 to 31 December 2004. While the extension of the business elements of this scheme will be subject to approval under EU State aid rules, no such approval is required in relation to the residential elements of the scheme.

The termination date for the qualifying period for the Park and Ride scheme is being extended from 30 June 2004 to 31 December 2004.

To align the Student Accommodation Scheme with the other schemes and to conform with the new calendar tax year, the termination date for the qualifying period for this scheme is being brought forward from 30 September 2005 to 31 December 2004.

To conform with the new calendar tax year, the termination date for the qualifying period for investment in film production under section 481 of the Taxes Consolidation Act 1997 is being moved from 5 April 2005 to 31 December 2004.

Capital Allowances for Hotels The special regime of capital allowances of 15% per annum over 7 years in respect of hotels and holiday camps is being terminated on and from 4 December 2002. The general industrial buildings allowance of 4% per annum over 25 years will apply to expenditure incurred on the construction or refurbishment of such buildings or structures from that date. Transitional provisions will apply which will provide for the continued availability of the special regime in relation to those hotel buildings and holiday camps where binding contracts are evidenced in writing before 4 December 2002 and the expenditure is incurred by 31 December 2003.

This measure is estimated to yield €3 million in 2003 and €30 million in a full year when the phasing out of these allowances is completed.

Capital Allowances for Holiday Cottages The scheme of capital allowances of 10% per annum over 10 years in respect of holiday cottages is being terminated on and from 4 December 2002. Transitional provisions will apply which will provide for the availability of this 10% per annum rate in relation to those holiday cottages where binding contracts are evidenced in writing before 4 December 2002 and the expenditure is incurred by 31 July 2003.

This measure is estimated to yield €1 million in 2003 and €8 million in a full year when the phasing out of these allowances is completed.

Capital Allowances for Plant & Machinery and Business Motor Vehicles
The write-off period for the annual wear and tear capital allowances for plant and machinery is being extended from 5 to 8 years. At present the allowances operate on a straight line basis over a five year period, i.e. 20% per annum. In future an allowance of 12.5% per annum on a straight line basis will apply. This measure will apply to general plant and machinery as well as to business motor vehicles (excluding taxis and short-term hire vehicles which will retain their 40% per annum reducing balance arrangement). This measure will apply as respects expenditure incurred on or after 4 December 2002, except where a binding contract is evidenced in writing before that date and the expenditure is incurred by 31 January 2003.

This measure is estimated to provide a cash-flow yield to the Exchequer of €20 million in 2003, €105 million in 2004, €191 million in 2005, €269 million in 2006, €315 million in 2007, €259 million in 2008 and €150 million in 2009.

	1998	1999	2000	2001	2002	2003	2004	2005	2006
Manufacturing Industries (NACE 15-37)	**Manufacturing Industries (NACE 15-37)**	**Manufacturing Industries (NACE 15-37)**	**Manufacturing Industries (NACE 15-37)**	**Manufacturing Industries (NACE 15-37)**	**Manufacturing Industries (NACE 15-37)**	**Manufacturing Industries (NACE 15-37)**	**Manufacturing Industries (NACE 15-37)**	**Manufacturing Industries (NACE 15-37)**	**Manufacturing Industries (NACE 15-37)**
All Persons	374.82	396.55	423.24	456.97	483.02	511.78	534.24	557.57	575.21
Average annual wage	19,491	20,621	22,008	23,762	25,117	26,613	27,780	28,994	29,911
Increase on 1998 base	100%	106%	113%	122%	129%	137%	143%	149%	153%
Average of new and 2nd hand House Prices (Euro)	129,916	155,919	179,871	194,490	212,943	244,733	271,929	303,310	338,542
Increase on 1998 base	100%	120%	138%	150%	164%	188%	209%	233%	261%

Average annual wage taken from CSO http://www.cso.ie/quicktables/GetQuickTables.aspx?FileName=QIJA.asp&TableName=Industrial+Earnings&StatisticalProduct=DB_QI

Average increase of house prices taken from CSO http://www.cso.ie/px/pxeirestat/Statire/SelectVarVal/saveselections.asp
CSO/Home/Statbank/Housing Statistics/HSQ06/Select from table HSQ06

We can also reject $b_{S0}=b_{C0}$ and $b_{S1}=b_{C1}$ in seven of the eight cases using conventional significance levels. The parameters that affect the classification probabilities appear to be more precisely estimated using Irish data. As with British data the results suggest that the bubbles model fit the data reasonably well. An answer to our first question asked in the introduction to the paper is that there is also some evidence that a speculative bubble exists in Irish house prices.

In Figure 4(a) we present an estimate of the bubble (measured on the left-hand side) and the probability of a fall in excess returns (measured on the right-hand side). In Figure 4(b) we present an estimate of the bubble and the probability of a crash in excess returns. We estimate that Irish fundamental house prices fluctuated within 5 per cent of actual house prices up to 1996. Since 1997 the estimated bubble has grown but not as rapid as what happened in Britain in the late 1980s. Between 1979-1997 the probability of a crash (or even a fall) in real house prices has remained more or less constant. However, the probability of a crash in real second-hand house prices has recently increased to around 2 per cent. It would appear the current Irish market fundamentals are much stronger than what occurred in Britain in the late 1980s.

V CONCLUSIONS

There has been much comment and debate in the media about the current boom in Irish house prices. Some commentators have suggested that there may be a speculative bubble in the housing market. Others have suggested that a crash similar to Britain in the late 1980s would not occur here. We employ recently developed testing procedures for speculative bubbles based on regime-switching models to evaluate these remarks. Our findings indicate that there is some evidence of speculative bubble in Irish house prices but the probability of a crash is much lower than that estimated for Britain in the late 1980s. The evidence is strongest when we use methods to calculate fundamental house prices similar to those used in the first Bacon report.

Economic forecasts for Ireland are for the continuation of the current economic boom and for possibly lower interest rates. This will have a tendency to increase the demand for housing well into the next millennium. If the increased demand is not matched by supply, house prices will inevitably rise even further. If a bubble already exists in the market the problem will be exacerbated and the probability of a crash will most likely increase. Recently announced government policies of land rezoning to increase supply should be implemented as soon as possible. Future research will focus on the factors that may cause speculative bubbles in the housing market and on the possibility of regime-switching in fundamentals.

THEME: R2

Effectiveness of the supervisory practice (Central Bank, Financial Regulator and Department of Finance)

LINE OF INQUIRY: R2c

Adequacy of the assessment and communication of both solvency and liquidity risks in the banking institutions and sector

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Appendix A

5 September 2007

Oifig an Aire Airgeadis

Aide Memoire for the Government

Financial Markets Developments

1. Matter-Issue for Information
The Tánaiste submits this Aide Memoire to inform the Government of recent developments in the financial markets and their possible impact on Ireland

2. Background-Reason for Aide Memoire
There was considerable turbulence in the global financial market for credit during August, triggered by difficulties in the US subprime market, ie the US market providing mortgages to less creditworthy customers.

As interest rates increased in the US, customers for this category of lending were finding it increasingly difficult to meet their obligations, leading to a re-evaluation of the value of securities issued using mortgage obligations as collateral. As it was difficult for lenders and investors to identify easily which institutions were exposed to these assets, and similar assets in other parts of the world, a generalised shortage of credit materialised, leading to particular difficulties for banks and other institutions with a high reliance on shorter term wholesale credit. Central Banks, especially the ECB and the Federal Reserve, responded by injecting funds (liquidity injections) into the interbank market, which helped considerably in easing tensions, but was of less use to non-bank financial institutions.

The shortage of credit has led to difficulties in a number of firms around the world – examples are Barclays, Bear Stearns, Banque Nationale de Paris and certain German banks, including one – SachsenLB – which has had to be sold to stronger buyers.

It should be noted that much of this difficulty has arisen not because there is necessarily a deficiency in the asset quality of investments made by these institutions or their offshoots (although this may turn out to be the case in some instances) but because in an uncertain market, wholesale lenders have been unwilling to provide funds to them. As a result they have had to sell assets quickly or call on their sponsoring banks to provide funds (often on foot of pre-existing credit lines or guarantees) – in the Sachsen case, the German head office could not meet its obligations without assistance.

3. Special Purpose Vehicles
Certain Special Investment Vehicles (conduits) operating in or otherwise connected to Ireland (for example by having a company registration or stock exchange listing here) have been involved. The difficulties encountered by some of these individual conduits has drawn media attention to the regulation of such firms in Ireland, even though such firms are spread widely around the world – of around 50 such vehicles with German sponsoring banks, for example, only 7 are in Ireland.

4. Irish Impacts

These developments have not seriously affected the Irish domestic financial system but obviously there would be concern about the potential for reputational damage to Ireland as a financial centre. The attached report summarises the Central Bank/Financial Regulator view on recent Irish developments and on the broader picture.

On the longer term economic situation, the report indicates that it is as yet too early to ascertain whether the global credit difficulties could begin to have an effect beyond the purely financial realm and result in damage to the real economy in the form of production and jobs. So far this has not happened to any significant extent, but there is a danger that ongoing uncertainty could impact on interest rates and credit availability.

On regulatory issues, the Financial Regulator is being proactive in protecting the reputational standing of the IFSC, both through regulatory action and considerable briefing of the media, but there are still risks.

5. Conclusions

Taking into account the assessment by the Bank and the Regulator in the attached report, and the Department of Finance's own examination, the following points can be made:

- So far the dislocation in global financial markets has had only a limited effect on the Irish domestic financial sector and the Irish economy.
- Our regulatory regime is well up to international standards and there is no question of the IFSC being any less regulated than the best regulated financial centres elsewhere
- ***Confidential:*** the Regulator is watching closely any firms which it believes may be under stress in current circumstances – while the number of such firms is small, it cannot be ruled out that one or more could run into some level of difficulty.
- Subprime lending is a very small segment of the overall Irish domestic market (whether such lending takes place at home or abroad). However, the Department of Finance has already been working on legislation to apply additional consumer protections to this sector (and to equity release lending), with a view to inclusion by way of amendment to an existing Bill
- The Department of Finance will continue to monitor the situation closely and the Tánaiste will make a further report to Government as appropriate.

Government Press Release

The Government has taken the decision today, in light in particular of recent developments in the international financial environment and their affect on the stability of the Irish financial system to guarantee the retail, wholesale deposit and inter-bank lending [**check scope**] of the six domestic credit institutions (i.e. Allied Irish Bank, Bank of Ireland, Anglo Irish Bank, Irish Life and Permanent, Irish Nationwide Building Society and the Educational Building Society.

This decision has been taken by Government in close consultation with the Central Bank and Financial Regulator to remove any uncertainty on the part the counterparties and customers of these institutions. The Government's objective in taking this decisive action is to maintain financial stability in Ireland against the backdrop unprecedented turmoil in the international financial system.

The Government has been closely monitoring the unprecedented conditions prevailing in international financial markets particularly over recent weeks which have impacted severely on Irish financial institutions and in particular their access to normal wholesale funding. This measure has been taken as a response to the severe dysfunction in international credit markets which is seriously impacting on the funding position of the domestic credit institutions. The Financial Regulator has advised that all the domestic financial institutions are solvent and are subject to normal ongoing regulatory requirements.

The Government stressed that the guarantee is being provided on strictly commercial terms to the institutions concerned and will be subject to specific terms and conditions as necessitated where considered appropriate.

As international uncertainty has continued to increase and the turmoil has intensified, the issue of this guarantee is a pre-emptive measure by Government to give certainty to customers and the market about the underlying strength and resilience of Irish financial institutions.

All institutions should continue to operate as normal.

The Government guarantee will remain in place, initially for six months. Appropriate notice will be given to the markets in advance of lifting this guarantee.

Throughout the current period of turmoil the Government has stressed its commitment to the stability of the Irish financial system and in particular that money placed with an Irish credit institution would not be at risk. This measure is therefore a concrete demonstration of the Government's determination to protect the soundness and stability of the Irish financial system overall.

This Government has taken this very important step to safeguard the Irish financial system to remedy what would otherwise be a serious economic disturbance in the economy on account of the very disturbed and uncertain international financial environment.