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REPORT of the Joint Committee of Inquiry into the Banking Crisis

Houses of the Oireachtas
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Volume 1: Report
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Financial Stability Issues – Scoping Paper

1. Introduction

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

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

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

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

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

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

If an institution is experiencing liquidity difficulties[1] and has exhausted any opportunities for accessing liquidity in the wholesale maket the first step should be for it to seek liquidity from the European Central Bank (ECB) in normal operations. This liquidity would of course require eligible collateral. In Ireland, a large proportion of banks balance sheets can be used as collateral for liquidity provision; through for example the use of mortgage backed promissory notes. Intensive use of eligible assets for liquidity under "normal" Eurosystem conditions is likely to be noticed by the market. If this liquidity is not sufficient to restore liquidity to the institution, the institution may approach the CBFSAI for emergency liquidity assistance (ELA). The view of the CBFSAI is that the requirement for the ELA provision to an Irish bank would signify the existence of a serious threat to the long-term sustainability of the financial institution in question because of the 'stigma' that would attach to it. It is important to highlight, therefore, that ELA provision would be an interim measure while urgent consideration was given by all parties to the available options for rescuing the bank.

3.1 CBFSAI role in this situation

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

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

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

3.2 <u>Department/Minister's role in this situation</u>

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

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

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

3.3 Impact of ELA provision on confidence in the institution

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

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

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

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

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

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

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

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

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

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

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

- **The Takeover Code**
  This legislation forces takeover bids to be disclosed and sets out a long procedure for takeovers – the Governor of the Bank of England, Mr Mervyn King, said that this prevented him from organising a takeover and presenting it as a "done deal"
- **The Market Abuse Directive**
  This defines what behaviour is considered insider dealing and provides for disclosures to the market – Mr King said this meant that any lending operations to Northern Rock had to be disclosed.
- **The insolvency regime in the Enterprise Act 2002**
  This provides a framework for the winding up of companies – for banks it means that depositors have their accounts frozen. Mr King said that this made it rational for people to queue for their deposits back
- **The Financial Services Compensation Scheme**
  This sets out the rules for the limited guarantees on UK banking deposits – Mr King said that the fact that this only covered up to £35,000 made it more important for people to withdraw their money from Northern Rock.

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

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

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

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

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

i) It would cause moral hazard as the institution expects that the State will intervene and it will be rescued if it should run into difficulties.

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

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

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

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

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

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

4.3 Role/Legal powers of the Minister in this situation

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

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

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

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

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

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

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

4.4 Principles guiding public intervention

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

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

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

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

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

Common Principles for cross-border financial crisis management

1. The objective of crisis management is to protect the stability of the financial system in all countries involved and in the EU as a whole and to minimise potential harmful economic impacts at the lowest overall collective cost. The objective is not to prevent bank failures.

2. In a crisis situation, primacy will always be given to private sector solutions which as far as possible will build on the financial situation of a banking group as a whole. The management of an ailing institution will be held accountable, shareholders will not be bailed out and creditors and uninsured depositors should expect to face losses.

3. The use of public money to resolve a crisis can never be taken for granted and will only be considered to remedy a serious disturbance in the economy and when overall social benefits are assessed to exceed the cost of recapitalisation at public expense. The circumstances and the timing of a possible public intervention can not be set in advance. Strict and uniform conditions shall be applied to any use of public money.

4. Managing a cross-border crisis is a matter of common interest for all Member States affected. Where a bank group has significant cross-border activities in different Member States, authorities in these countries will carefully cooperate and prepare in normal times as much as possible for sharing a potential fiscal burden. If public resources are involved, direct budgetary net costs are shared among affected Member States on the basis of equitable and balanced criteria, which take into account the economic impact of the crisis in the countries affected and the framework of home and host countries' supervisory powers.

5. Arrangements and tools for cross-border crisis management will be designed flexibly to allow for adapting to the specific features of a crisis, individual institutions, balance sheet items and markets. Cross-border arrangements will build on effective national arrangements and cooperation between authorities of different countries. Competent authorities in the Member States affected by a crisis should be in a position to promptly

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

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

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

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

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

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

Appointment of a receiver for all or part of the assets

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

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

There are three form of winding up:

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

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

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

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

- in the interests of depositors.

Liquidation has a number of practical effects:

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

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

Appointment of an Examiner (Court Protection)

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

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

Critical Banking Functions

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

The recent UK discussion paper 'Banking reform – protecting depositors – indicates there different approaches to resolving bank difficulties in other countries. The US has a distinct insolvency regime for banks involving wide powers for special administrators appointed to carry out resolutions. These special administrators are generally answerable to the banking regulator rather than the courts. Bridge Banks involves either the transfer of the assets and liabilities of the existing legal entity to a new legal entity or the transfer of the existing legal entity to new openers. The new (bridge) bank would then continue to provide the critical banking functions while either a recapitalisation or a permanent transfer of business to new owners was organised. Some European countries have special arrangements for banks in trouble including provisions for authorities to appoint special or provisional administrators with discretion over the initiation of measures, including the ability to apply them to banks before they are technically insolvent.

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

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

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

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

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

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

State Aid and Northern Rock

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

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

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

4.7 Deposit Guarantee Scheme:

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

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

An issue arises as to how a payout of the scheme would be funded. Currently the DGS stands at €455 million. However it is likely that the requirement to compensate depositors would be greater than this figure. There is a requirement in the Deposit Guarantee Directive Regulations on the CBFSAI to pay all eligible depositors. The CBFSAI have therefore concluded that it is implied that if the DGS is not sufficient to meet the loss amount the CBFSAI must meet the balance. The Regulations allow the CBFSAI to go back out to credit institutions and seek additional contributions. It is considered though that these contributions are limited to the initial amount in the fund. It is unclear whether, if more than twice the current value of the fund was required, the CBFSAI could or should cover the balance. The question also arises of the pace at which participating credit institutions would be in a position to replenish the DGS fund and the implications for maintaining the attractiveness of Ireland as an investment location for banks, since they can provide services from abroad on a broad basis.

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

The two possible uses of the DGS identified are:

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

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

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

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

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

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

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

Urgent Next Steps

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

Company Law intervention Mechanisms

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

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

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

Appointment of a receiver

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

Appointment of a liquidator

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

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

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

Members and creditors voluntary winding up

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

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

Compulsory winding up under a Court appointed liquidator

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

6 The CBFSAI is entitled to prior notice and a hearing in relation to any petition to wind up a bank The Bank may also petition for the winding up of a bank on four grounds i.e. that it may be unable to meet its obligations to creditors, has failed to comply with a direction under S21 of the CBA 1971, has ceased to carry on banking, or in the interests of depositors. Where a bank is being wound up voluntarily the Bank may also apply on these grounds to have it wound up by the Court (S48 CBA 1989). The Bank has similar powers in relation to Building Societies (S 1 09 BSA 1989).

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

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

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

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

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

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

Appointment of an Examiner (court protection)

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

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

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

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

13 The examiner has 2 principal functions:

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

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

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

Appointment of Inspectors or intervention of the Director of Corporate Enforcement

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

Structural Changes to the Company

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

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

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

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

Stock Exchange considerations

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

Some Tentative Assumptions and Conclusions

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

- *Where the institution is substantially viable (or has a significant "goodwill value') a market solution (takeover or merger) may be the preferred option or the target of any short term intervention.*

- *Company law intervention would of its nature only from part of any package to assist a troubled financial institution, and would probably accompany or follow measures to support its liquidity.*

- *The Court Protection (Examinership) procedure seems to offer the least difficulties and most advantages of all the procedures except possibly in the case of dire insolvency.*

- *If Court Protection is recognised as the most useful of the tools available there may be scope for fine tuning aspects of the legislation governing the initiation of the process (e.g. use of CBFSAI data) to render it more user friendly.*

- *It is doubtful if an effective form of support or supervisory action (intermediate between short term liquidity support and company law intervention) could be devised which would enable a credit institution to continue trading in a normal or near normal manner.*

- *There is a need to explore further the nature of deposits as liabilities of a credit institution and the related question of when or if a liquidity problem affecting their repayment on time would constitute insolvency (as in unable to meet liabilities as they fall due).*

Goodhart approach to deposit protection

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

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

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

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

THEME: C2

Role and effectiveness of the Policy appraisal regime before and during the crisis

LINE OF INQUIRY: C2b

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

IFSC Clearing House Group

The IFSC Clearing House Group identifies and considers issues of major concern to the long-term development of the international financial services industry in Ireland, including the strategic development of new business areas and the progress of relevant legislation.

The Group also monitors the activity of Working Groups on Banking and Treasury, Funds, Asset Management, Pension Funds and Insurance. The Group seeks to settle by itself, or by reference to the Taoiseach and the Government, problems which have been identified but not resolved by these Groups.

The Group is chaired by the Secretary General to the Government and membership is restricted to senior industry and public sector representatives. The Chairmen of each of the Working Groups are also members of the IFSC Clearing House Group.

"Pat Farrell"
<pat.farrell@ibf.ie>
15/10/2008 08:31

To <dermot.mccarthy@taoiseach.gov.ie>
cc
bcc
Subject FW: ACS

Dermot

We need your support on this – IFSC banking has been completely overlooked. The issue is as relevant to retail banks as to covered bond banks at IFSC.

Pat

Pat Farrell
Chief Executive
Irish Banking Federation
t: + 353 1 474 8832
m: [redacted]

From: Hugh Friel **On Behalf Of** Paul O'Connor
Sent: 14 October 2008 15:29
To: kevin.cardiff@finance.gov.ie
Cc: 'William W.B. Beausang (william.beausang@finance.gov.ie)'; Brosnan Frank; Pat Farrell; barry.oleary@ida.ie
Subject: ACS

Kevin
Please find below some points in relation to the DEPFA situation and the rationale for inclusion of DEPFA ACS Bank PLC and WestLB Covered Bond Bank PLC in the guarantee. We believe that support for ACS is now of significant importance and urgently request some statement of political support as per the German example.
The German declaration includes a very strong commitment of the government to do everything to protect Pfandbriefe against any damage. If necessary, legal measures will be taken to ensure the functioning of the Pfandbrief market. The German text is as follows:

Das Gesetz erfasst in weitem Umfang Finanzinsititute und Finanzmarktinstrumente. Die Einbeziehung von Pfandbriefen erschien demgegenüber derzeit nicht geboten. Pfandbriefe sind durch die besonderen gesetzlichen Regelungen in Deutschland schon jetzt sicher – in der über 200-jährigen Geschichte des Produktes ist noch nie ein deutscher Pfandbrief ausgefallen. Die Bundesregierung wird dafür Sorge

without a significant injection of over-collateralisation in the form of cash, which has not to date been forthcoming. However, the inclusion of all ACS Covered Bond banks (as a separate category) in the Government's bank guarantee structure would be evidence of tangible Irish Government support and an endorsement of the robust nature of the Irish legislation. It would also go a considerable way to mitigating the already very negative effect that the downgrade of DEPFA ACS has had on the ACS market.
Support for the ACS market now is important to ensure the access of Irish banks to covered bonds as a funding mechanism in the medium term, beyond financial turmoil. .I would welcome your attention to this matter.
With regards
Paul

Paul P. O'Connor
Head of Wholesale Banking and Risk
Irish Banking Federation

[redacted]

EUROPEAN CENTRAL BANK
EUROSYSTEM

Jean-Claude TRICHET
President

An Taoiseach, Mr. Brian Cowen, T.D.
Department of the Taoiseach,
Government Buildings,
Upper Merrion Street,
Dublin 2,
Ireland.

16 October 2008

L/JCT/08/1657

Dear Taoiseach,

RE: Credit Institutions (Financial Support) Scheme 2008

The ECB was recently consulted on the draft Credit Institutions (Financial Support) Scheme 2008, which was published on the website of the Department of Finance this morning. I understand that the draft scheme is still subject to the approval of the Oireachtas.

Under paragraph 10 of the Schedule to the draft scheme, the liabilities covered under the Minister for Finance's guarantee of certain liabilities of systemically important credit institutions designated by the Minister under the scheme include interbank deposits and senior unsecured debt. I am writing to request that the Irish Government arrange that interbank deposits with a maturity of up to three months be excluded from the liabilities covered under the draft scheme. In this respect, I would like to draw your attention to the ECB opinion on the draft scheme[1], which was adopted yesterday by the ECB Governing Council. In its opinion the ECB attached great importance to the declaration made by the euro area Heads of State on 12 October 2008[2], according to which Member States have to act in a coordinated manner to avoid that significant differences in national implementation could have a counter-productive effect, creating distortions in banking markets. The euro area Heads of State also acknowledged the need to work in cooperation with the ECB so as to ensure consistency with the management of liquidity by the Eurosystem and compatibility with the operational framework of the Eurosystem. Against this background, the ECB opinion notes that uncoordinated decisions to guarantee interbank deposits in some Member States should be avoided as they may involve a fragmentation of the euro area money market.

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[1] See paragraph 3.7 of ECB Opinion CON/2008/48 of 15 October 2008 at the request of the Irish Minister for Finance on a draft Credit Institutions (Financial Support) Scheme 2008, available at: http://www.ecb.europa.eu/ecb/legal/opinions/html/index.en.html

[2] 'Declaration on a concerted European action plan of the euro area countries', available on the website of the French Presidency at www.ue2008.fr.

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The extension of the guarantee to cover interbank deposits, as is the case under the draft scheme, could entail a substantial distortion in the various national segments of the euro area money market by potentially increasing short-term debt issuance activity across Member States and therefore impairing the implementation of the single monetary policy, which is a competence of the Eurosystem under Article 105(2) of the Treaty.

The ECB opinion also highlights the statement in the declaration that the euro area Governments would make available a Government guarantee of new medium term (up to 5 years) bank senior debt issuance, whereas the scheme proposes to cover senior unsecured debt and asset covered securities, and dated subordinated debt (Lower Tier 2), without limitation as to maturity.

I am writing to underline the importance that the ECB attaches to the exclusion of interbank deposits with a maturity of up to three months from the liabilities covered by the draft scheme. I would wish that the Irish Government would maintain such an exclusion until this matter has been fully coordinated throughout the euro area Member States, in order to avoid distortions in the implementation of the euro area single monetary policy.

Yours truly,

cc. Mr. Brian Lenihan, T.D.,
Department of Finance,
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Ireland.

Mr. John Hurley,
Governor,
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EUROPEAN CENTRAL BANK

EUROSYSTEM

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Pierre van der Haegen
Director General
Secretariat and Language Services
European Central Bank

OPINION OF THE EUROPEAN CENTRAL BANK

of 15 October 2008

at the request of the Irish Minister for Finance

on a draft Credit Institutions (Financial Support) Scheme 2008

(CON/2008/48)

Introduction and legal basis

On 10 October 2008 the European Central Bank (ECB) received a request from the Irish Minister for Finance (hereinafter the 'Minister') for an opinion on a draft Credit Institutions (Financial Support) Scheme 2008 (hereinafter the 'draft scheme') to be adopted by the Minister by means of a statutory instrument under the provisions of the Credit Institutions (Financial Support) Act 2008 (hereinafter the 'Act'). On 13 October 2008 the ECB was informally provided by the Irish Department of Finance with an updated version of the draft scheme (hereinafter the 'updated draft scheme')[1]. The scheme implements the more general rules contained in the recently adopted Act, on which the ECB has been consulted and issued its Opinion CON/2008/44 on 3 October 2008[2]. In accordance with the Act, the Minister may not adopt the scheme until a resolution approving it has been passed by each House of the *Oireachtas* (National Parliament)[3]. The Minister requested the ECB's opinion on the scheme as a matter of urgency, prior to its submission to the *Oireachtas*.

The ECB's competence to deliver an opinion is based on Article 105(4) of the Treaty, in conjunction with the third and sixth indents of Article 2(1) of Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions[4], as the scheme relates to a national central bank, the Central Bank and Financial Services Authority of Ireland (hereinafter the 'Central Bank'), and contains rules applicable to financial institutions insofar as they materially influence the stability of financial institutions and markets. In accordance with the first sentence of Article 17.5 of the Rules of Procedure of the European Central Bank, the Governing Council has adopted this opinion.

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1 The draft scheme and the updated draft scheme are only referred to specifically in this opinion where a distinction needs to be made between them. Otherwise the legislative provisions to be adopted are referred to as the 'scheme'.

2 See ECB Opinion of 3 October 2008 at the request of the Irish Minister for Finance on a draft Credit Institutions (Financial Support) Bill 2008 (CON/2008/44).

3 See Section 6(5) of the Act.

4 OJ L 189, 3.7.1998, p. 42.

1. Purpose of the scheme

1.1 The primary objective of the scheme is to provide a legal basis for the Minister to stand as guarantor of the 'covered liabilities' of a 'covered institution' for the period of two years from 30 September 2008 to 29 September 2010, as a form of financial support provided under the Act[5]. In accordance with the Act, the scheme has been brought forward as the Minister is of the opinion that: (i) there is a serious threat to the stability of credit institutions in Ireland generally, or would be such a threat if he did not provide the financial support; (ii) the provision of the financial support is necessary, in the public interest, for maintaining the stability of the financial system in Ireland; and (iii) the provision of the financial support is necessary to remedy a serious disturbance in the economy of Ireland[6].

1.2 The scheme further specifies the scope of the State's guarantee by clarifying the means by which credit institutions are covered by the scheme and the types of liabilities of the covered institutions for which the State guarantee will be provided, as further discussed in paragraph 3 of this opinion. A covered institution will be under an obligation to pay a quarterly charge to the State for a guarantee, calculated on the basis of, *inter alia*, its risk profile[7]. The scheme confers extensive powers on the Minister, the Governor of the Central Bank and the Irish Financial Services Regulatory Authority (hereinafter the 'Regulatory Authority'), as further discussed in paragraph 4 of this opinion.

2. General observations

2.1 The ECB notes that there is an ongoing discussion at both the international and European levels with a view to coordinating the many diverse actions of countries aimed at preserving confidence and stability in the international financial markets. In line with the common principles to guide the action of Member States agreed at the Ecofin meeting on 7 October 2008: (i) interventions should be timely and the support should in principle be temporary; (ii) the interests of taxpayers should be protected; (iii) existing shareholders should bear the due consequences of the intervention; (iv) the government should be in a position to bring about a change of management; (v) management should not retain undue benefits; (vi) governments may have, inter alia, the power to intervene with regard to remuneration; (vii) legitimate interests of competitors must be protected, in particular through the State aid rules, and negative spill-over effects should be avoided[8]. Moreover, the ECB notes that on 12 October 2008 the Heads of State of the euro area issued a 'Declaration on a

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5 See paragraph 9 of the Schedule to the scheme. The scheme does not concern other types of financial support which may be provided by the Minister under the Act, such as, for example, the Minister's authority to purchase shares in a supported credit institution under Section 6(9) of the Act.

6 See paragraph 1 of the Schedule to the scheme.

7 The charge is to be credited to a designated account to be maintained at the Central Bank as a reserve for any payments to be made under the scheme (see paragraphs 15A-21 of the Schedule to the draft scheme (paragraphs 16-23 of the Schedule to the updated draft scheme), together with the Annex (Guarantee Charging Model) to the Schedule).

8 See the press release of the 2894th Council meeting (13784/08), available on the Council website, www.consilium.europa.eu.

concerted European action plan of the euro area countries'[9], in which they confirmed their commitment to act together in a decisive and comprehensive way in order to restore confidence and proper functioning of the financial system, aiming at restoring appropriate and efficient financing conditions for the economy. They agreed on common principles to be followed by the EU and euro area governments, central banks and supervisors to avoid national measures adversely affecting the functioning of the single market and the other Member States. Against this background, the ECB highlights that all the initiatives put in place by national governments to restore the confidence in financial markets should be aimed at implementing such common principles, in the spirit of close cooperation with other Member States and EU institutions.

2.2 The ECB underlines that the recommendations expressed in this opinion in relation to the scheme should be taken together with the recommendations expressed by the ECB in relation to the draft Act in its Opinion CON/2008/44[10]. The ECB wishes to draw the consulting authority's attention to the recent ECB opinions issued at the request of other Member States, whereby the ECB has commented on legislative proposals sharing some of the features of the scheme[11]. It is the ECB's intention to facilitate coordination of the various national efforts addressing the current financial situation, inter alia through timely adoption and publication of ECB opinions on such draft national legislation.

3. Scope of the financial support provided

3.1 *Selection of covered credit institutions*

Under the scheme on which the ECB was originally consulted, the institutions covered are those credit institutions and subsidiaries which the Minister, following a recommendation from the Governor of the Central Bank, specifies by order under the Act as requiring financial support[12]. A credit institution joins the scheme by executing a guarantee acceptance deed in the form to be specified by the Minister and, if required by the Minister, its parent or any other group company also executing such a guarantee acceptance deed[13]. A subsidiary of any parent credit institution which is not regulated by the Regulatory Authority may qualify as a 'covered institution', but in the case of a covered institution which is a subsidiary of any non-Irish parent credit institution, the only liabilities covered would be those which relate to the subsidiary's own business[14].

3.2 In the context of the above provisions, the ECB notes that on 30 September 2008 the Irish Government announced that it had decided to put in place a two-year guarantee arrangement to

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9 See the declaration of 12 October 2008, available on the website of the French Presidency at www.ue2008.fr.

10 See in particular paragraphs 2.3 and 3.2 of Opinion CON/2008/44, as reiterated in paragraphs 3.4 and 3.7 of this opinion.

11 See, e.g. ECB Opinion CON/2008/46 of 8 October 2008 at the request of the Belgian Ministry of Finance on a preliminary draft law on measures promoting financial stability and in particular establishing a State guarantee for the provision of credit in the context of financial stability. All ECB opinions are available on the ECB website at www.ecb.europa.eu/ecb/legal/opinions/html/index.en.html.

12 See paragraph 3 of the Schedule to the scheme.

13 See paragraph 5 of the Schedule to the updated draft scheme.

14 See paragraph 12 of the Schedule to the updated draft scheme.

safeguard liabilities with six explicitly named Irish credit institutions and such specific subsidiaries as may be approved by the Government following consultation with the Central Bank and the Regulatory Authority[15]. The ECB notes that on 9 October 2008 the Minister announced that the two-year scheme would also be available to five explicitly named 'banking subsidiaries' in Ireland 'with a significant and broad-based footprint in the domestic economy'[16]. Against this background, the ECB has the following comments.

3.3 *First*, the ECB notes that the original proposal whereby the Governor of the Central Bank would be entrusted with the authority to 'make recommendations' to the Minister as regards the credit institutions to be covered by the scheme has been modified by the updated draft scheme to the effect that the Minister would instead take a decision to designate those systemically important credit institutions which the Minister specifies require financial support. Given that the purpose of the scheme is to maintain the stability of the Irish financial system, the original proposal to confer this particular role on the Governor would have complemented the Governor's financial stability role under the Act[17] and, more generally, the Central Bank's statutes[18]. The Governor's financial stability role at domestic level also facilitates the discharge of his responsibilities as a member of the ECB's Governing Council to contribute to the stability of the wider European and global financial systems under Article 105(5) of the Treaty. The ECB would have a preference to revert to the original proposal and in any case ensure a proper involvement of the Governor when taking any decision under the scheme with a bearing on financial stability, including all decisions by the Minister to revoke the guarantee in whole or in part in relation to a credit institution.

3.4 *Second*, the ECB reiterates the stance taken in its previous opinion, according to which arrangements which may be seen as providing preferential treatment to specified credit institutions should be avoided[19]. In this respect, the ECB appreciates the provision of the scheme stating that it is introduced by the Minister having regard to the objective of ensuring compliance with the requirements of EU State aid and competition law[20], as well as the statements made in the explanatory memorandum to the effect that the scheme is designed to ensure that the covered institutions will not be unfairly advantaged by making undue use of their guaranteed status to engage in a heightened level of activities which create market distortions and facilitate abnormal

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15 See the 30 September 2008 press release, available on the Department for Finance's website at www.finance.gov.ie. Cf. paragraph 19 of ECB Opinion CON/2008/44.

16 See the 9 October 2008 press release, available on the Department for Finance's website at www.finance.gov.ie.

17 See the list of the Governor's relevant powers in paragraph 3.1 of ECB Opinion CON/2008/44.

18 The financial stability powers of the Governor under the Central Bank Acts include: (i) expressing agreement to actions by the Regulatory Authority on any matter relating to the financial stability of Ireland's financial system, including (but not limited to) the issue, revocation and suspension of a license or other authority; (ii) authorising investigations and on-site inspections of licensed credit institutions; (iii) the issuance of guidance as to policies and principles that the Regulatory Authority is required to implement in performing the Central Bank's functions; and (iv) requesting the Regulatory Authority's advice, information and assistance. See Sections 33C(1)(c), 33C(8), 33C(9), 33C(9A), 33C(9B) and 33D(1)-(2) of the Central Bank Act 1942; Section 17A of the Central Bank Act 1971; Section 41 of the Central Bank Act 1989.

19 See paragraph 2.3 of ECB Opinion CON/2008/44.

20 See paragraph 2, fourth bullet point, of the Schedule to the draft scheme (paragraph 2.5 of the Schedule to the updated draft scheme).

balance sheet growth[21]. In this regard, the ECB underlines the importance of establishing appropriate safeguards such as for example limits to marketing of financial products or limits to expansion of activities on the basis of the state guarantees[22].

3.5 The ECB understands that the Commission has confirmed the compatibility of the guarantee arrangement proposed by the Irish Government with Community State aid rules[23]. The ECB reiterates the importance of ensuring that the further regulatory practice under the proposed arrangements will be conducted in full compliance with the relevant Community law provisions, in particular as regards competition and State aid rules, as well as EU financial services legislation and the single market principles[24].

3.6 *Types of liabilities covered by the guarantee*

Under the scheme 'covered liabilities' are defined as those liabilities of covered institutions existing on 30 September 2008 or at any time thereafter up to and including 29 September 2010 in respect of: (i) all retail and corporate deposits (to the extent not covered by existing deposit protection schemes in Ireland or any other jurisdiction); (ii) interbank deposits; (iii) senior unsecured debt; (iv) covered bonds; and (v) dated subordinated debt (Lower Tier 2)[25]. In the case of a covered institution which is a subsidiary of any non-Irish parent credit institution, the only covered liabilities would be those which relate to the subsidiary's own business and in respect of which there is no recourse to any other entity (and would not include liabilities which, in the absence of the guarantee, would normally be those of other members of the covered institution's group)[26].

3.7 As a further comment as regards the scope of coverage of the State guarantee, the ECB notes that, in line with the declaration made by the euro area Heads of State mentioned before, Member States have to act in coordinated manner to avoid that significant differences in national implementation could have a counter-productive effect, creating distortions in global banking markets. The euro area Heads of State also acknowledged the need to work in cooperation with the ECB so as to ensure consistency with the management of liquidity by the Eurosystem and compatibility with the operational framework of the Eurosystem. Against this background, the ECB notes that uncoordinated decisions to guarantee interbank deposits in some Member States should be avoided as they may involve a fragmentation of the euro area money market. The extension of the guarantee

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21 See the Explanatory Memorandum Relating to a Scheme Dated X day of October 2008, pp. 2-4.

22 See in particular the safeguards introduced by paragraph 36 of the updated draft scheme.

23 See the Commission press release IP/08/1497 of 13 October 2008. The non-confidential version of the Commission's decision will be made available under Case NN 48/2008. The Commission took account, in particular of the provision of the updated draft scheme stating that the Minister may review and vary the scheme at no later than six-month intervals, and the results of such review will be provided to the Commission (see paragraph 8 of the Schedule to the updated draft scheme). See also 'Communication from the Commission – The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis' of 13 October 2008, available at the Commission's website at www.ec.europa.eu.

24 Cf. paragraph 2.3 of ECB Opinion CON/2008/44.

25 See paragraph 10 of the Schedule to the scheme.

26 See paragraph 12 of the Schedule to the updated draft scheme.

to cover interbank deposits, as is the case under the scheme[27], could entail a substantial distortion in the various national segments of the euro area money market by potentially increasing short-term debt issuance activity across Member States and therefore impairing the implementation of the single monetary policy, which is a competence of the Eurosystem under Article 105(2) of the Treaty. The ECB also notes that the summit declaration states that the euro area Governments would make available a Government guarantee of new medium term (up to 5 years) bank senior debt issuance, whereas the scheme proposes to cover senior unsecured debt and asset covered securities, without limitation as to maturity, and dated subordinated debt (Lower Tier 2)[28].

3.8 The draft scheme on which the ECB was formally consulted indicates that it remains to be clarified whether the covered liabilities would exclude any inter-group lending and any debt due to the ECB[29]. The exclusion of debts due to the ECB from the liabilities covered by the guarantee under the scheme would be incongruous, however. Under the Act the borrowings, liabilities and obligations of any credit institution or subsidiary in respect of which the Minister may provide financial support include borrowings, liabilities and obligations to the Central Bank[30]. This would imply that the following liabilities to the Central Bank would be covered liabilities under the scheme: (i) deposits made by the Central Bank with covered Irish credit institutions as part of the Central Bank's investment operations; and (ii) senior unsecured debt securities and covered bonds issued by Irish credit institutions covered by the scheme and held by the Central Bank as collateral in the Central Bank's Eurosystem monetary policy and intra-day credit operations[31]. By contrast, deposits made by the ECB with these same Irish credit institutions as part of the ECB's investment operations would not be covered liabilities under the scheme. As a practical matter, this would, in all probability, provide a strong incentive to the ECB to refrain from making deposits with such Irish credit institutions in the future, since the ECB could no longer rely on the normal credit ratings attributed to exposures with these Irish banks, which would be based on the presence of the Minister's guarantee[32].

3.9 The ECB further understands that because of the abovementioned inclusion of covered institutions' liabilities towards the Central Bank within the scope of the State guarantees provided under the scheme[33], the Central Bank may find itself in a situation where it is lending to a credit institution against collateral which may, at least partially, take the form of a guarantee provided by the State.

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27 See paragraph 10, second bullet point of the draft scheme and paragraph 10.2 of the Schedule to the updated draft scheme.

28 See paragraph 10, third, fourth and fifth bullet points of the draft scheme and paragraph 10.3-10.5 of the Schedule to the updated draft scheme.

29 See paragraph 10 of the Schedule to the draft scheme.

30 See Section 6(2) of the Act.

31 Any secured lending by the Central Bank to covered institutions, e.g. as part of the Central Bank's Eurosystem credit or emergency lending operations would not appear to be covered by the scheme.

32 If the intention behind this proposal was to exclude obligations arising out of Eurosystem monetary policy and intraday credit operations, care would need to be taken that such an exclusion did not also require a reappraisal of the eligibility of senior unsecured debt securities and covered bonds issued by Irish credit institutions covered by the scheme in connection with the collateralisation of Eurosystem credit operations.

33 See Section 6(2) of the Act.

Such central bank lending to a solvent credit institution on the basis of a State guarantee is, in principle, possible, provided that the Central Bank's compliance with the monetary financing prohibition under Article 101 of the Treaty is ensured. Specific criteria for such compliance must be respected as noted by the ECB in a recent opinion issued with respect to another EU jurisdiction which has legislated in response to the current market turmoil[34]. In this opinion, the ECB underlines its earlier recommendation that nothing in the legal framework governing the provision of financial support by the Irish authorities should prejudice the Central Bank's compliance with the prohibition on monetary financing under Article 101 of the Treaty[35].

3.10 Finally, as regards the payment of the claims in respect of covered liabilities, the ECB highlights that in general the existing funding mechanism of the deposit-guarantee scheme should be used to the extent possible. In this respect, in fact, the ECB notes that the scheme covers all retail and corporate deposits to the extent they are not covered by existing protection schemes in the State or any other jurisdiction[36]. However, the ECB notes that the relationship between the scheme and the existing deposit guarantee scheme as regards the treatment of claims and the reimbursement of deposits should be further clarified.

4. Allocation of supervisory powers related to provision of financial support

4.1 The scheme confers extensive powers on the Minister, the Governor of the Central Bank and the Regulatory Authority, which are divided as follows.

(i) The Minister has the power to: (i) impose specific obligations on covered institutions which are subsidiaries of non-Irish parent credit institutions to ensure that the scheme is not used for the benefit of any entity other than the relevant covered institution[37]; (ii) in consultation with the relevant overseas regulator (subject to the requirements of the Treaty and the ESCB Statute), require certain obligations of the scheme to apply to the parent of a covered institution or any member of its group[38]; (iii) receive confirmations from covered institutions regarding compliance with relevant regulatory standards[39] and (through covered institutions' auditors) with the conditions of the scheme[40]; (iv) direct, following consultation with the

34 See paragraph 4.3 of ECB Opinion CON/2008/46. This opinion specified the following criteria under which a central bank may engage in lending to a solvent credit institution on basis of a collateral in the form of a State guarantee: (i) the central bank needs to independently exercise full discretion regarding the decision whether to extend emergency liquidity assistance; (ii) it should be ensured that the credit provided by the central bank is as short term as possible; (iii) there must be systemic stability aspects at stake; (iv) there must be no doubts as to the legal validity and enforceability of the State guarantee under applicable national law; and (v) there must be no doubts as to the economic adequacy of the State guarantee, which should cover both principal and interest on the loans, thus fully preserving the financial independence of the central bank.

35 See paragraph 3.2(iii) of ECB Opinion CON/2008/44.

36 See paragraph 10, first bullet point of the Schedule to the draft scheme (paragraph 10.1 of the Schedule to the updated draft scheme).

37 See paragraph 11 of the Schedule to the draft scheme (paragraph 12 of the Schedule to the updated draft scheme).

38 See paragraph 50 of the Schedule to the scheme.

39 For example, the Irish Bankers' Federation Code of Practice on Mortgage Arrears and the Regulatory Authority's Consumer Protection Code (see paragraph 24 of the Schedule to the draft scheme (paragraph 26 of the Schedule to the updated draft scheme)).

40 See paragraph 25 of the Schedule to the draft scheme (paragraph 27 of the Schedule to the updated draft scheme).

Governor and the Regulatory Authority, a covered institution to submit a restructuring plan to ensure compliance with the objectives of the scheme[41]; (v) direct a covered institution to appoint non-executive directors to its board from a panel approved by the Minister and admit observers appointed by the Minister to observe the meetings of the internal committees of the covered institution[42]; (vi) direct a covered institution to take specified steps to restructure its executive management responsibilities, strengthen its management capacity and improve its corporate governance[43]; (vii) impose sanctions on the covered institution, if in the opinion of the Minister it is in material breach of its obligations under the scheme[44]; (viii) following consultation with the Governor and the Regulatory Authority, prevent a covered institution from acquiring shares in any other credit or financial institution, establishing any subsidiaries or entering into or acquiring any new business where this would increase the State's liability under the guarantee[45]; (ix) following consultation with the Governor and the Regulatory Authority, make rules governing the payment of dividends by a particular covered institution[46]; (x) establish an independent oversight committee to impose controls on the executive remuneration of covered institutions[47]; and (xi) in the event of any default of a covered institution which creates a liability on the State, direct the covered institution concerning its business and corporate structures[48].

(ii) The Governor of the Central Bank has powers to: (i) together with the Regulatory Authority, set regulatory requirements for the covered institutions[49]; (ii) together with the Regulatory Authority and following the consultation with the Minister, require a covered institution to conduct its affairs in a manner that progressively reduces the risk to the State under its Guarantee[50]. Further, the Governor may be consulted by the Minister regarding institutions to be covered under the scheme[51]. The Governor is also consulted by the Minister before the Minister exercises any functions under the scheme which relate to the Governor's statutory

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41 See paragraph 26 of the Schedule to the draft scheme (paragraph 28 of the Schedule to the updated draft scheme).

42 See paragraph 30 of the Schedule to the draft scheme (paragraph 32 of the Schedule to the updated draft scheme).

43 See paragraph 34 of the Schedule to the scheme. A similar power may be exercised by the Regulatory Authority.

44 See paragraph 35 of the Schedule to the scheme. Acting in this capacity, the Minister may increase the charge payable by the institution, impose additional conditions or revoke the institution's guarantee.

45 See paragraph 36 of the Schedule to the draft scheme (paragraph 38 of the Schedule to the updated draft scheme).

46 See paragraph 41 of the Schedule to the draft scheme (paragraph 42 of the Schedule to the updated draft scheme). The rules concerning payment of dividends should take into account the objective of achieving or maintaining required capital ratios.

47 See paragraphs 46-49 of the Schedule to the scheme.

48 See paragraph 53 of the Schedule to the draft scheme (paragraph 53.4 of the Schedule to the updated draft scheme), which also provides that any restructuring plan drawn up for a covered institution in such a case should be notified to the European Commission and should comply with EU State aid and competition law.

49 See paragraph 4 of the Schedule to the scheme.

50 See paragraph 37 of the Schedule to the scheme. The Governor may in particular require a covered institution to: (i) appropriately manage its balance sheet in a manner consistent with the purposes of the Act and the need to avoid significant distortion of financial flows; (i) put in place improved structures to ensure long-term stability of funding; (iii) take steps to restructure its executive management responsibilities and strengthen its management capacity and corporate governance; (iv) improve liquidity, solvency and capital ratios in circumstances where this is required; and (v) take measures to minimise any risk of recourse to the guarantee.

51 See paragraph 3 of the Schedule to the updated draft scheme.

responsibilities[52], as well as with respect to the exercise of certain more specific powers of the Minister under the scheme[53]. The Governor monitors, together with the Regulatory Authority's Chief Executive, the operation of the scheme and reports regularly to the Minister thereon[54].

(iii) The Regulatory Authority, apart from the abovementioned functions performed jointly with the Governor: (i) receives (on behalf of the Minister) from the covered institutions reports, addressing their key supervisory parameters[55] and submits to the Minister reports on the compliance by covered institutions with the terms and conditions of the scheme[56]; (ii) after consultation with the Minister, may require a covered institution to establish appropriate funding structures[57]; (iii) if so directed by the Minister, may require any report or other information to be provided by a covered institution to be audited by an independent auditor[58]; (iv) is consulted by the covered institutions towards developing a code of practice for effective risk management, in furtherance of the purposes of the Act[59]; (v) may, following consultation with the Minister, require changes in the composition of a covered institution's board in order to achieve an appropriate balance between executive and non-executive directors[60]; and (vi) may, after consultation with the Minister, require changes in the specific elements of the commercial conduct of the covered institution[61].

4.2 On the one hand, the ECB welcomes those provisions of the draft scheme that allow the Governor to be involved in the exercise of the Minister's powers under the Act and the scheme for purposes of maintaining the stability of the Irish financial system. Moreover, the ECB welcomes the express safeguards introduced under the draft scheme as regards the role of the Governor, in particular the clarifications that: (i) nothing in the scheme shall prejudice the independence of the Governor[62]; (ii) the Governor's authority to disclose information concerning a covered institution or its subsidiaries to the Minister and the Regulatory Authority is subject to the confidentiality

52 See paragraph 51 of the Schedule to the scheme.

53 See consultation powers given to the Governor under paragraphs 13, 26, 36, 39 and 41 of the Schedule to the draft scheme (the Schedule to the updated draft scheme provides for such consultation powers in four cases, referred to in paragraphs 13, 28, 38 and 42).

54 See paragraph 52 of the Schedule to the scheme.

55 See paragraph 22 of the Schedule to the draft scheme (paragraph 24 of the Schedule to the updated draft scheme). The parameters in question include, inter alia, liquidity requirements, capital ratios, asset quality, risk exposures and funding costs.

56 See paragraph 23 of the Schedule to the draft scheme (paragraph 25 of the Schedule to the updated draft scheme).

57 See paragraph 40 of the Schedule to the updated draft scheme.

58 See paragraphs 25 and 27 of the Schedule to the draft scheme (paragraphs 27 and 29 of the Schedule to the updated draft scheme).

59 See paragraphs 29 of the Schedule to the draft scheme (paragraph 31 of the Schedule to the updated draft scheme).

60 See paragraph 33 of the Schedule to the scheme.

61 See paragraphs 38, 40, 43 and 44 of the Schedule to the draft scheme (paragraphs 36, 39, 41 and 44 of the Schedule to the updated draft scheme). The elements of commercial conduct to be regulated by the Regulatory Authority under these provisions include: (i) targets on loan/deposit ratios, wholesale funding/total liabilities, deposit growth and maximum loans-to-value on new loans; (ii) limitations on exposures to any sector, customer or connected customers; (iii) liquidity, solvency and capital ratios; (iv) restrictions in relation to market share and balance sheet growth introduced to minimise any potential competitive distortion that may otherwise arise; (v) directions for the covered institution to cease passing on the costs of the guarantee to its customers in an unwarranted manner.

62 See paragraph 51 of the Schedule to the scheme.

requirements imposed on the Governor by the Treaty and the ESCB Statute[63]; and (iii) the Governor's monitoring and regular reporting to the Minister regarding the operation of the scheme is without prejudice to the Governor's responsibility for the performance of functions conferred on the Governor and the Central Bank under the Treaty and the ESCB Statute[64]. These provisions satisfactorily incorporate, as far as the draft scheme is concerned, the recommendations made in this respect in the recent ECB opinion on the Act[65].

4.3 On the other hand, the ECB notes that the division of responsibilities to be performed in the implementation of the scheme by the Minister, the Governor and the Regulatory Authority provides the Minister with substantive powers to review, direct or otherwise influence the conduct of the credit institutions concerned. The ECB appreciates that the Minister must protect the financial interests of the Irish taxpayer[66]. However, the ECB would also wish to draw attention in this context to the principle of operational independence of banking supervisors, which are to pursue supervisory objectives free from political pressure, which is an internationally recognised supervisory standard specified in the Basel Core Principles for Effective Banking Supervision[67]. In line with its previous opinions[68], the ECB recommends that the allocation of powers related to the operation of the scheme be reconsidered, with a view to assigning to the Regulatory Authority and/or the Governor those powers under the scheme that are closely connected with the performance of supervisory tasks.

4.4 As a general remark, the ECB notes that the powers conferred under the scheme could be defined in a more coherent way. For example, in the updated draft scheme there appears to be an overlap between the two separate references to the functions of requiring the covered institution to 'put in place improved structures to ensure long-term stability of funding'[69] or to 'restructure its executive management responsibilities, strengthen its management capacity and improve its corporate governance'[70]. Also, a greater consistency in the method of allocating the various powers under the

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63 See paragraph 28 of the Schedule to the draft scheme (paragraph 30 of the Schedule to the updated draft scheme).

64 See paragraph 52 of the Schedule to the scheme.

65 See paragraph 3.2 (i)-(ii) of ECB Opinion CON/2008/44.

66 See paragraph 2, first and fourth bullet point of the Schedule to the draft scheme (paragraph 2.6 of the Schedule to the updated draft scheme).

67 See the Basel Committee on Banking Supervision, 'Core Principles for Effective Banking Supervision', September 1997, principle I, document available on the Bank for International Settlements website, www.bis.org.

68 See, e.g. paragraph 3.2.1 of ECB Opinion CON/2006/15 of 9 March 2006 at the request of the Polish Minister of Finance on a draft law on the supervision of financial institutions.

69 Under paragraph 37.2 of the updated draft scheme 'the Governor and the Regulatory Authority, after consultation with the Minister' may direct the covered institution to '[p]ut in place improved structures to ensure long-term stability of funding', while under paragraph 40 of the Schedule to the updated draft scheme states that 'Unless it has already done so, a covered institution shall take steps to establish such funding structures as the Regulatory Authority, in consultation with the Minister, thinks appropriate having regard to the purposes of the Act of 2008, within such period as the Minister may direct'.

70 Under paragraph 34 of the Schedule to the updated draft scheme, this power is assigned to 'the Minister or the Regulatory Authority or both', whereas under paragraph 37.3 of the Schedule to the updated draft scheme the power is attributed to 'the Governor and the Regulatory Authority, after the consultation with the Minister'.

draft scheme could be ensured[71]. The ECB recommends that a more coherent delineation of the powers of the respective supervisory authorities is introduced.

This opinion will be published on the ECB's website.

Done at Frankfurt am Main, 15 October 2008.

The Vice-President of the ECB

Lucas D. PAPADEMOS

71 For example, paragraph 42 of the updated draft scheme provides that the power to limit the payment of dividends by the covered institution is to be exercised by the Minister after consulting the Governor and the Regulatory Authority, while the similar power under paragraph 43 of the updated draft scheme to prohibit the covered institution from engaging in buy-backs or redemptions of its ordinary shares is to be exercised by the Regulatory Authority after consulting the Minister.

THEME: C2

Role and effectiveness of the Policy appraisal regime before and during the crisis

LINE OF INQUIRY: C2c

The liquidity versus solvency debate

(6)

International Economic Consultants

Indecon

Status: Personal and Strictly Confidential

Addressee Only

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

25th September, 2008

Dear Kevin,

Please find a confidential personal note in the attached envelope.

Kind personal regards,

Yours sincerely,

Alan W. Gray

Indecon (Ireland), Indecon House, 4 Fitzwilliam Place, Dublin 2, Ireland.
phone: + 353 1 677 7144 **fax:** + 353 1 677 7417 **email:** mailbox@indecon.ie **web:** www.indecon.ie

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International Economic Consultants

Indecon

Status: Personal and Strictly Confidential

Addressee Only

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

25th September, 2008

Dear Kevin,

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

If I can be of any further assistance just call.

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

Kind personal regards,

Yours sincerely,

Alan W. Gray

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

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CHALLENGES

A. **IMPROVE LIQUIDITY IN BANKING SECTOR.**

B. **RESPONSE TO INDIVIDUAL BANKS WITH SPECIFIC LIQUIDITY ISSUES.**

C. **ACTIONS TO REDUCE RISK AND POTENTIAL EXCHEQUER EXPOSURE IN SPECIFIC INDIVIDUAL BANKS.**

D. **PLANNING TO FACILITATE RESTRUCTURING OF SECTOR.**

A. Improve Liquidity in Banking Sector

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

B. Response to Individual Banks with Specific Liquidity Issues

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

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

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

D. Planning for Restructuring of Sector

Needs significant thought and analysis.

Principles Inherent in Above Analysis

(i) State exposure to be minimised where possible.

(ii) The knock on impacts of any decisions taken into account and minimisation of contagion.

(iii) The cost of any assistance to be paid for fully by the sector (even if this means over time).

(iv) Wider economic implications factored in.

DATE ? ~ about 25/9/08

(6)

6

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

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

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

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

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

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

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

Attendance:

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

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

Minister from D. Doyle

Supplementary Budget

1. As you know I have been very concerned for some time about the financial markets and their relationship with Government funding and flows to the banking sector. I gave you a note about this on 21 January (copy attached). Since then over €50 billion has left the country.

2. It is essential that the Government, on 7 April, have a credible and marketable fiscal adjustment plan. This needs to

- have a clear downward trajectory for the Government deficit
- have detailed spending and tax measures identified for 2009, 2010 and 2011 with a framework for 2012/3.

3 I suggest that the Government tonight adopt the trajectory that it wants to achieve for the Deficit for the next five years.

(i) The nominal GGD trajectory in the absence of policy change is now likely to be:

	2009	2010	2011	2012	2013
GGB % of GDP	-12¾ to -13%	-17½%	-17%	-17¼%	-16%

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

	2009	2010	2011	2012	2013
GGB % of GDP	-10½%	-11%	-8%	-5¾%	-3%

4. I would also suggest that the Government move tonight towards identifying the measures it is willing to adopt. We can then reflect on what the impact of these measures on getting to the approved trajectory might be and can update you and the Taoiseach tomorrow.

5. Notes attached set out taxation and expenditure measures for consideration.

6. Finally, on a practical note, the Government would need to identify the bulk of measures by Sunday next with final decision by Tuesday next so that the Budget can be produced on target.

24 March 2009