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REPORT of the Joint Committee of Inquiry into the Banking Crisis

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

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

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Table of contents – by line of inquiry

C4: Appropriateness and effectiveness of domestic policy responses

C4b: Establishment, operation and effectiveness of NAMA

C5: Appropriateness and effectiveness of international, Ireland-specific policy responses

C5a: EU/IMF /ECB programme of assistance

THEME: C4

Appropriateness and effectiveness of the domestic policy responses

LINE OF INQUIRY: C4b

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

OIFIG AN AIRE AIRGEADAIS

Ref No: **March 2009**

SECRET

Memo for Government

Proposal for a National Asset Management Agency

1. Decision Sought

The Minister for Finance requests the Government to note:

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

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

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

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

2. Background

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

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

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

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

3. Options Available to Government

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

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

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

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

A more detailed assessment of these options is at Appendix 2

4. Bacon favours an Asset Management Agency

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

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

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

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

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

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

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

6. The scale and cost of assets to be transferred

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

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

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

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

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

7. **Impact on National Debt**

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

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

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

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

8. Consensus in favour of scaled back option

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

9. Implications of creating an Asset Management Agency

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

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

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

10. Immediate Liquidity needs.

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

11. Review of the Bank Guarantee Scheme

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

12. EU implications

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

Appendix 1:

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

Overview:

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

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

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

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

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

Summary:

1. Crisis in Irish Banking:

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

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

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

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

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

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

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

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

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

2. Constraints on the Public Finances:

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

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

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

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

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

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

3. Dealing with Loan Losses:

The report considers three options for tackling the related market uncertainties around capital levels in the banks, and the extent of liability of the State.

A. Recapitalisation:

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

B. Asset Guarantee:

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

C. Asset Purchase:

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

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

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

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

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

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

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

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

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

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

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

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

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

4. Proposal for a National Asset Management Agency:

Functions to be carried out by a NAMA comprise:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Appendix 2 – Strategic Options

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

Take no further action

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

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

Establish an insurance scheme

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

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

Asset Management Agency

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

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

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

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

Appendix 3

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

Aggregated Bank Balance Sheet- Before

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

Aggregated Bank Balance Sheet - After

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

Asset Management Company Balance Sheet

Assets		Liabilities	
Bank Loans	€120	Gov Debt	€120

Government Balance Sheet

Assets		Liabilities	
Loan to AMC	€120	Increased Gov Debt	€120

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

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

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

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

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

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

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

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

Appendix 5: Guarantee Scheme Review

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

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

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

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

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

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

(a) dated subordinated debt (Lower Tier 2);
(b) asset covered securities; and
(c) senior unsecured debt that matures or extends beyond the expiry of the Guarantee on 29 September 201

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

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

Appendix 6: State aid aspects to the Bacon report

Background

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

Eligible Assets

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

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

Cost to the State

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

Eligible institutions

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

Valuation process etc.

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

THEME: C5

Appropriateness and effectiveness of international, Ireland-specific policy responses

LINE OF INQUIRY: C5a

European Union (EU) / International Monetary Fund (IMF) / European Central Bank (ECB) programme of assistance

S29421c

3

Address by an Taoiseach, Brian Cowen, T.D., to EU Heads of Mission, 9 December 2010

Ladies and Gentlemen,

Can I begin by thanking Ambassador Robert Devriese for hosting today's lunch. It is a great pleasure to be here and I look forward to our discussions.

I would also like take the opportunity to pay tribute to Belgium, and to Spain before it, for the effective and efficient way in which you have run your Presidencies. For any Member State, big or small, the undertaking is a demanding one at the best of times. Both countries have more than risen to the challenge in 2010.

As I don't get to meet with this group very often, I thought the best use of our time together would be for me to make some introductory remarks and then to take a few questions.

2010 – An Exceptionally Difficult Year

There is no escaping it, 2010 has been an exceptionally difficult year for Ireland.

In the past three years, like the rest of the developed world, we have had to come to terms with new economic realities. For a number of reasons, this has been a more difficult journey for Ireland than for most.

We are a small open trading economy, with all the vulnerabilities that brings. When the world experiences an economic shock, Ireland cannot avoid feeling the brunt of it. This is evident in our employment levels, our tax receipts and our welfare costs.

Also, when global credit began to dry up, Ireland was left with a banking system that had grown to disproportionate size, based on a toxic combination of cheap credit and reckless lending practices. The scale of the problems in the sector has only come to reveal itself fully over time.

Ireland could probably have handled the consequences of either one of these challenges on our own.

While we have a serious and significant imbalance in our public spending, we have been taking strong and deep measures in order to bring income and expenditure into line, and into keeping with the strictures of the Stability and Growth Pact.

We have also dedicated huge resources and time to seeking to resolve the enormous difficulties in the banking sector.

In the end, however, tackling both sets of difficulties together became a challenge too big for us to manage on our own, under current market conditions.

We are, therefore, very appreciative of the support of our partners in the EU – Member States and institutions – and the IMF for the significant assistance that they have made available to Ireland, particularly in recent weeks.

The phrase 'we are where we are' has become something of a cliché in public discussions in Ireland in recent times. But let me be clear, where we are in Ireland today is not where any Government or people would wish to find themselves.

We are a proud and independent people and it is not easy for us to find ourselves relying on the support of others, albeit on our good friends in the EU.

I therefore want to reassure you today that we are utterly determined to get back to standing on our own feet as quickly as we possibly can.

The Road to Recovery

In late November we published a National Recovery Plan covering the period from now until 2014. Shortly afterwards, we agreed a programme of action with the EU institutions and the IMF. On Tuesday, we brought forward the budget for 2011.

All three pull in the same direction.

Taken together, they chart the way forward towards sustainable growth and recovery.

Ireland is determined to reach the deficit target of 3% of GDP as rapidly as we can. We have already made adjustments of €14.5 billion in the last two years, and will take out another €15 billion in the period between now and 2014. Under the Programme agreed with our EU partners, we have been given more room for manoeuvre – until 2015 – in case growth prospects don't turn out to be as positive as has been predicted.

The adjustment of €15 billion is broken down into €10 billion in spending reductions - €7 billion on the current side and €3 billion on capital side - and €5 billion in revenue raising measures.

To make our seriousness of intent plain, and to get ourselves into a better position as rapidly as possible, €6 billion of this adjustment will be made in 2011.

As this week's budget demonstrates, this will require a contribution from all sections of society.

I appreciate fully that the impact of the budget will be difficult for many of our citizens. But we carefully considered all the options and possibilities available to us. We have taken very tough decisions in order to balance protecting the most vulnerable in our society, with the need to meet our international obligations, and the need to promote economic growth and employment.

We have brought forward a budget that we believe bears evenly on people and shares the burden fairly.

Getting the economy back on track is not just a story of cutting spending and raising revenues, vital as these steps are. It is also about continuing to put in place strategies and measures to improve competitiveness, foster growth and create employment.

Specifically, we have decided to reduce the minimum wage by €1 per hour and to reform the welfare system to remove unemployment traps and to provide incentives to get more people back to work. We are also putting reinvigorated activation policies in place, to help unemployed people make as swift a return to employment as possible.

We will bring real competition to bear in the professions, including measures to reduce legal costs.

We will aim to reduce waste and energy costs faced by business and to enhance availability of technological infrastructure, especially next generation broadband.

We are also determined to increase efficiency in the public sector and to reduce costs for the private sector. This will be tough.
We are committed to reducing the cost of public sector pay and pensions. We will implement overall payroll adjustments of €1.2 billion by 2014. Public service staff numbers will be cut by 24,750 from end-2008 levels. There will be a reformed pension

scheme for new entrants to the public service and they will enter on pay 10% below those already serving.

We will make more efficient use of staffing resources, with redeployment of staff within and across sectors of the public service to meet priority needs.

Reform of the Banking Sector

We have also charted the way forward on reforming our banking sector.

Of course, a great deal has already been done to manage difficulties in this sector. We have transferred the banks' riskiest loans to NAMA, and a detailed capital adequacy assessment made in the summer has been followed up with significant capitalisation measures.

But it was clear that markets did not yet have sufficient confidence.

Therefore, the Programme agreed with our international partners builds on the measures already taken, providing for a fundamental downsizing and reorganisation of the banking sector.

This will lead to a smaller banking system, more proportionate to the size of the economy, capitalised to the highest economic standards, with renewed access to normal market sources of funding and focused on strongly supporting the recovery of the economy.

Much of the funding for the banks in the external assistance programme will be provided on a contingency basis, to be drawn down only if required, helping to hasten a reformed banking system and rendering it better placed to serve the needs of the economy.

The Prospects for Recovery are Good

Taken together, this represents a reasonable, if challenging, programme for moving forward again. And I believe that the prospects for recovery are better than many would allow.

We are now seeing a stabilisation of our public finances and renewed export-drive growth. From a drop of 7.6% in 2009, we expect modest growth of 0.3% in GDP this year and average annual growth of 2.75% per annum between now and 2014.

Recovery is gaining pace due to increased competitiveness combined with increasing international demand for our goods and services – a virtuous circle. Exports increased by nearly 7% in the first half of this year. Manufacturing is up by 12% in the third quarter. The labour market has stabilised.

We are moving towards a positive balance of payments in 2011, meaning that the economy as a whole is paying down external debt.

We have a strong and diversified economy. Good infrastructure. High quality human capital – the youngest best educated population. A strong multi-national sector and vibrant native industrial base. We have tax policies that favour entrepreneurship, investment and work.

Not least, we are a resilient and capable people.

The European Dimension

Ladies and Gentlemen,

I am conscious that so far I have spoken about Ireland and its difficulties. But I am acutely aware that they must be seen alongside the difficulties being experienced by the European Union and the eurozone in particular.

As a member of the European Council I have seen how economic and currency issues have dominated our agenda this year.

The economic crisis has stress-tested our arrangements for economic governance and found them wanting. There is, however, consensus in favour of taking the steps necessary to improve them.

Thanks to the work of the Task Force chaired by European Council President Van Rompuy we now have a template for increased fiscal discipline, broadened economic surveillance with a stronger focus on debt sustainability, and deepened economic coordination. We are establishing a more robust framework for crisis management. Preparation of the legislation to give effect to the Task Force Report is being fast-tracked through the system.

When we meet next week, the European Council will take further decisions, including on the wording of a limited Treaty change necessary to establish a permanent crisis mechanism to safeguard the financial stability of the euro area as a whole.

Eurogroup Ministers have set out some detail of what this mechanism should look like and I expect that will be reflected in what President Van Rompuy brings to next week's Council meeting.

I firmly hope that, with these measures, we will see confidence restored to the markets as soon as possible.

We have recently seen all sorts of wild speculation as to the future of the euro and even of the European Union itself. And, while I believe that much of this speculation has been enormously wide of the mark, I do share Chancellor Merkel's view that the health of the euro and the health of the Union are inextricably linked.

I also strongly share the view of the President of the European Central Bank, Jean Claude Trichet, that observers tend to underestimate the determination of decision-makers in Europe to do what is necessary to protect our interests.

This is a testing time. To some extent we are collectively on a war-footing. As President Trichet has said, it is a time for careful and precise communication – for clarity and for discipline in what we say.

Yes we need to consider our options for the future. But we need to do so in a careful, reflective and considered way.

We cannot create policy from soundbites. We have to be thorough, strategic and long-term in our thinking, not just driven by day-to-day movements in the markets.

Confidence is something that you grow and nurture carefully. It doesn't just spring up overnight. It is built through actions more than through words.

Conclusion

Finally, I would like to take this opportunity to thank you all for the work that you do in communicating developments in Ireland to your respective capitals. It has, I imagine, been a busy year for you all. I hope that the holiday season will give you and your families a chance to wind down and to reflect on the most important things in life – health, happiness and hope for the future.

Thank you.

ENDS

EUROPEAN CENTRAL BANK

EUROSYSTEM

Strictly Confidential

Jean-Claude TRICHET
President

Mr Brian Lenihan
Tánaiste and
Minister for Finance
Government Buildings
Upper Merrion Street
Dublin 2
Ireland

COPY

Frankfurt, 15 October 2010
L/JCT/10/1280

Dear Minister,

I refer to our last phone conversation. As you know the ECB greatly appreciates the recent commitment of the Irish government to develop, in close cooperation with the Commission in liaison with the ECB, a multi-annual economic and fiscal adjustment strategy. Given Ireland's convincing track-record in fiscal adjustment, I am confident that your medium-term strategy will be successful in restoring fiscal sustainability and financial sector soundness.

In this context, I would like to draw your attention to a number of issues arising from the *extraordinarily large provision of liquidity by the Eurosystem to Irish banks* in recent weeks. The participation in Eurosystem credit operations is subject to rules. These include the requirement for the Eurosystem to base its lending operations with market participants on adequate collateral. Moreover, the General Documentation on Eurosystem monetary policy instruments and procedures requires our counterparties to be financially sound. In this context, the Eurosystem may limit, exclude or suspend counterparties' access to monetary policy instruments on the grounds of prudence and may reject or limit the use of assets in the Eurosystem credit operations by specific counterparties. The Governing Council indeed carefully monitors the Eurosystem credit granted to the banking system, in the Irish as well as in all other cases, and in particular the size of Eurosystem exposures to individual banks, the financial soundness of these banks, and the collateral they provide to the Eurosystem. The assessment by the Governing Council of the appropriateness of its exposures to Irish banks depends very much on progress in economic policy adjustment, enhancing financial sector capital and bank restructuring.

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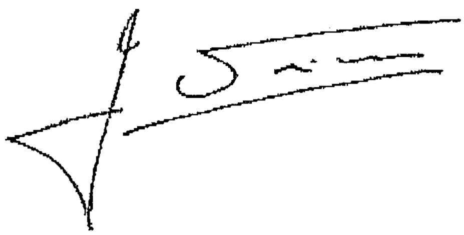
Moreover, the provision of *Emergency Liquidity Assistance (ELA)* by the Central Bank of Ireland, as by any other National Central Bank of the Eurosystem, is closely monitored by the ECB's Governing Council as it may interfere with the objectives and tasks of the Eurosystem and the prohibition of monetary financing under the Treaties. Therefore, if ELA is provided in significant amounts, the Governing Council will assess whether there is a need to impose specific conditions in order to protect the integrity of our monetary policy. In addition, in order to ensure compliance with the monetary financing prohibition, it is essential to ensure that the ELA recipient institution continues to be solvent.

Against the background of these principles, I would like to re-emphasize that the current *large provision of liquidity by the Eurosystem and the Central Bank of Ireland to entities such as Anglo Irish Bank should not be taken for granted as a long-term solution.* Given these principles, the Governing Council cannot commit to maintaining the size of its funding to these institutions on a permanent basis.

As I told you, a key element of the monitoring by the Governing Council of Eurosystem exposure to the Irish banking system, and the related decisions the Governing Council may take, will be its assessment of *progress in implementing the four-year economic strategy* that the Irish government envisages to announce in early November. This is not only because significant parts of the Irish banking systems are partially or fully Government owned, but also because an important share of the Eurosystem exposure to Irish credit institutions is collateralised with securities issued or guaranteed by the Irish Government. I trust that the four-year strategy will target a fiscal deficit of below 3% in 2014 and a decline in the public debt-to-GDP ratio from 2012/13 onward, based on cautious real growth forecasts, as well as a strong structural reform programme. Future decisions by the Governing Council of the ECB regarding the terms of liquidity provision to Irish banks will thus need to take into account appropriate progress in the areas of fiscal consolidation, structural reforms and financial sector restructuring.

With my best regards,



Cc.: Mr Olli Rehn, EU Commissioner for Economic and Monetary Affairs
Mr Joaquín Almunia, EU Commissioner for Competition

EUROPEAN CENTRAL BANK

EUROSYSTEM

Secret

Jean-Claude TRICHET
President

Reclassified for publication on 6 November 2014

Mr Brian Lenihan
Tánaiste and
Minister of Finance
Government Buildings
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Dublin 2
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Frankfurt, 19 November 2010
L/JCT/10/1444

Dear Minister,

As you are aware from my previous letter dated 15 October, the provision of *Emergency Liquidity Assistance (ELA)* by the Central Bank of Ireland, as by any other national central bank of the Eurosystem, is closely monitored by the Governing Council of the European Central Bank (ECB) as it may interfere with the objectives and tasks of the Eurosystem and may contravene the prohibition of monetary financing. Therefore, whenever ELA is provided in significant amounts, the Governing Council needs to assess whether it is appropriate to impose specific conditions in order to protect the integrity of our monetary policy. In addition, in order to ensure compliance with the prohibition of monetary financing, it is essential to ensure that ELA recipient institutions continue to be solvent.

As I indicated at the recent Eurogroup meeting, the exposure of the Eurosystem and of the Central Bank of Ireland vis-à-vis Irish financial institutions has risen significantly over the past few months to levels that we consider with great concern. Recent developments can only add to these concerns. As Patrick Honohan knows, the Governing Council has been asked yesterday to authorise new liquidity assistance which it did.

But all these considerations have implications for the assessment of the solvency of the institutions which are currently receiving ELA. It is the position of the Governing Council that it is only if we receive in writing a commitment from the Irish Government vis-à-vis the Eurosystem on the four following points that we can authorise further provisions of ELA to Irish financial institutions:

1) The Irish government shall send a request for financial support to the Eurogroup;

2) The request shall include the commitment to undertake decisive actions in the areas of fiscal consolidation, structural reforms and financial sector restructuring, in agreement with the European Commission, the International Monetary Fund and the ECB;

3) The plan for the restructuring of the Irish financial sector shall include the provision of the necessary capital to those Irish banks needing it and will be funded by the financial resources provided at the European and international level to the Irish government as well as by financial means currently available to the Irish government, including existing cash reserves of the Irish government;

4) The repayment of the funds provided in the form of ELA shall be fully guaranteed by the Irish Government, which would ensure the payment of immediate compensation to the Central Bank of Ireland in the event of missed payments on the side of the recipient institutions.

I am sure that you are aware that a swift response is needed before markets open next week, as evidenced by recent market tensions which may further escalate, possibly in a disruptive way, if no concrete action is taken by the Irish government on the points I mention above.

Besides the issue of the provision of ELA, the Governing Council of the ECB is extremely concerned about the very large overall credit exposure of the Eurosystem towards the Irish banking system. The Governing Council constantly monitors the credit granted to the banking system not only in Ireland but in all euro area countries, and in particular the size of Eurosystem exposures to individual banks, the financial soundness of these banks and the collateral they provide to the Eurosystem. The assessment of the Governing Council on the appropriateness of the Eurosystem's exposure to Irish banks will essentially depend on rapid and decisive progress in the formulation of a concrete action plan in the areas which have been mentioned in this letter and in its subsequent implementation.

With kind regards

Cc.: Mr Brian Cowen, Prime Minister

BN Merkel Debt Plan Provokes Selloff Trichet Foresaw: Euro Credit
Nov 3 2010 0:01:00

"The more you talk about restructuring debt, the harder it is to obtain debt," Irish Finance Minister Brian Lenihan said in an interview with Dublin-based RTE television yesterday. "That is the reality."

Merkel's stance echoes her approach to Greece earlier this year when she initially refused to rush to its aid, sparking speculation about the euro region's ability to handle the worst crisis in its history. While billionaire George Soros at the time said her strategy risked pushing Greece into a "death circle," Merkel said the "tough" terms of the country's eventual bailout vindicated her policy.

The new push comes as her Christian Democrat party loses support to the Social Democrats, with an Oct. 27 Forsa poll putting the opposition 12 percentage points ahead of her CDU-Free Democrat government. The government also faces regional elections from March that involve 25 percent of the population.

Time Bomb?

Leaving taxpayers to shoulder the burden of bailouts may set off "a dangerous social time bomb" of popular dissatisfaction, Finance Minister Wolfgang Schaeuble said in a speech late yesterday. "The currency union was never designed as a model for the enrichment of financial speculators."

Merkel's government was the biggest contributor to April's Greek bailout and would also shoulder the lion's share of any rescue under the current temporary backstop.

"These things are more about politics than economics," said Paul Lambert, head of the global macro team at Polar Capital Holdings Plc in London. "It's clear that for some economies in Europe it's going to be incredibly difficult to make the fiscal adjustments needed on their own. It's either going to mean Germany picking up the tab, or countries in Europe being cut loose."

The German proposals are hurting Portuguese debt even after the nation's government and biggest opposition party reached an agreement Oct. 29 on next year's budget. The country's bonds are the third-worst performing government debt securities this year, down 5.7 percent, according to indexes compiled by Bloomberg and the European Federation of Financial Analysts Societies.

Irish Spread

Only Greece, with a 16 percent decline, and Ireland, with a 6.9 percent drop, fared worse. German bonds earned more than 8.2 percent this year.

The spread on Irish bonds has doubled in the past three months as the government tries to cut its deficit in the face of bank-bailout costs that may reach 50 billion euros. The country's 10-year bond yesterday yielded 7.304 percent, the most since 1996.

"The German government is following what the market is telling it," said Nicola Marinelli, a portfolio manager at

BN Merkel Debt Plan Provokes Selloff Trichet Foresaw: Euro Credit
Nov 3 2010 0:01:00

Glendevon King Ltd. in London, which oversees $200 million in assts. "The Greek government, and probably the Irish and Portuguese, will need to be bailed out. If you sense that it's inevitable then it's better to have something to manage that than complete chaos."

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Independent.ie

Investors' fear sends yield on Irish bonds to new 7.45pc high

By Donal O'Donovan
Wednesday November 03 2010

The spiralling cost of Government borrowing hit a fresh high of 7.45pc yesterday as the European Central Bank (ECB) stepped in to calm the markets.

Germany's plan to get tough with bondholders, the failure to sell AIB's UK arm and fears that too much austerity could stifle the economy all added to the pressure on the bonds.

"The amount of selling has been relatively small, but the market is all sellers and no buyers, which drives up the yield. The ECB has come in to prevent this becoming a rout," said Padhraic Garvey, Head of Developed Markets Debt at ING Bank in Amsterdam.

Value

Yields of more than 7.4pc mean Irish 10-year bonds that pay 5pc in interest per year are being bought for a little more than 83pc of face value. Irish yields have now risen for six days in a row.

Bondholders have been selling Irish and other higher risk sovereign bonds since Germany proposed tough new bailout rules last week.

Under German Chancellor Angela Merkel's plan, lenders to sovereigns that are bailed out by the EU would take a haircut on their debt. If approved by EU members the proposals would come into force in 2013.

The EU needs a mechanism to manage defaults but holding discussions about the plan at a time when the market is so vulnerable has mystified many observers.

Yesterday Ms Merkel said that for rules to have have "more bite" to protect the euro, along with steps to prevent EU nations running up excessive debt, a crisis mechanism enshrined in the bloc's treaties is necessary for the longer term.

"We will set it up in such a way that European taxpayers will no longer be on the hook for possible new mistakes and turmoil on the financial markets," Ms Merkel said.

Fears that Ireland's austerity plans could hurt the economy are also turning some bondholders off Irish bonds. "With austerity measures you're damned if you do and damned if you don't. The market wants to see the cuts but at the same time fears they will hurt the economy," said Mr Garvey.

That adds to pressure on Finance Minister Brian Lenihan to produce a four-year plan that convinces investors who are now abandoning Irish debt to buy back in.

If the cuts he proposes are too deep, investors fear there will not be enough growth in the economy to revive the banks. If cuts are too shallow, investors won't believe the deficit can be brought under control.

The cost of insuring Irish bonds against default also hit a new high yesterday.

Credit Default Swaps (CDS) that insure bondholders against a default in the next five years cost 5.3pc early yesterday. This means a bondholder has to pay €530,000 to insure €10m of bonds against default. Bad news from AIB was one factor in the rising cost of insuring Irish bonds, which rose more sharply than Greek or Portuguese CDS, said Gavan Nolan, credit analyst at research firm Markit.

"The banking situation is an extra factor in Irish risk.

"On Tuesday Ireland underperformed the other peripherals after AIB said it could not sell its UK assets.

"That adds to the cost of the bank bailout for Ireland at a time when the sovereign debt market was already very nervy," Mr Nolan said.

- Donal O'Donovan

Financial Times

Debt costs jump for Dublin and Lisbon

By Richard Milne in London and Ralph Atkins in Frankfurt
Published: November 1 2010 19:41 | Last updated: November 1 2010 19:41

Borrowing costs for Ireland and Portugal shot up as investors took fright at European proposals to force them to take a greater share of losses in future state bail-outs.

The moves in the bond markets on Monday follow agreement at last week's European Union summit on a Franco-German proposal on a mechanism to resolve future Greek-style sovereign debt crises.

Ireland saw the premium it pays over German benchmark interest rates rise to 4.67 percentage points, while the yield on its 10-year bonds reached 7.14 per cent, up 0.22 percentage points. Both the premium and the yield set new records since the introduction of the euro.

Meanwhile, Portugal's yield rose 0.16 percentage points to 6.11 per cent, while Greece and Spain saw smaller rises and European banking shares fell sharply in a broadly flat market.

"People do seem shocked about the idea of a future eurozone debt restructuring – but this should not have been a surprise unless you really believed that the German taxpayer would always underwrite everything," said Erik Nielsen, Goldman Sachs European economist.

The rise in the yields of the so-called peripheral nations in the eurozone appears to fulfil the forecast of Jean-Claude Trichet, European Central Bank president, who warned European heads of state last week that the proposed rescue system would increase borrowing costs.

Gary Jenkins, head of fixed income at Evolution Securities, said the danger was that by talking about debt restructuring "it could become a self-fulfilling prophecy". Markets are particularly worried that borrowing costs for Ireland and Portugal could become so high that they are forced to tap the eurozone's bail-out fund, a potentially destabilising move.

Exacerbating the discord among Europe's leaders, a top ECB official on Monday sharply criticised Germany's plan to allow a debt rescheduling by a member state. "Calling for an orderly debt restructuring mechanism sounds nice and is costless. Designing and implementing it is somewhat different," Lorenzo Bini Smaghi, an ECB executive board member, said in a speech in Abu Dhabi.

Despite the soaring cost of borrowing – Greece's yields have risen by more than 1 percentage point in a week – the ECB made no purchases in its government bond-buying programme for the third week.

Separately, credit rating agency Moody's said Greece, Portugal and Ireland were likely to avoid sovereign bond defaults because of a strong domestic investor base of local banks and pension funds that would buy their government's debt even in times of stress.

Many investors, however, remain convinced that one or more countries, most likely Greece, will restructure. "You can't get away from the fact that there will be some kind of restructuring in the eurozone periphery," said Rod Davidson, head of fixed income at Alliance Trust Asset Management.

Additional reporting by David Oakley

Extracts from Embassy Summary of French Press Coverage

Paris Press summary, 3 November 2010

Foreign news stories, including the mid-term elections in the US, the Chinese State visit to France and continuing terrorist threats, make the headlines in Paris this morning.

1. Eurozone – Ireland

Le Figaro Economie reports on German Finance Minister Wolfgang Schaeuble's visit to Paris yesterday. "Eurozone: Berlin wants to make the private sector pay up; the German Finance Minister revealed.......his vision of the future mechanism for crisis resolution". The report describes Schaeuble as "an ardent defender of orthodoxy and a convinced partisan of tough measures to heal the ills of Euroland (sic)". Schaeuble set out his vision of the mechanism to resolve crises agreed last week by the European Council. The 27 agreed on the principles but gave themselves two months to work out the details, something that has not failed to cause concern on the markets. Unsurprisingly, Schaeuble defends a strict interpretation of the rescue mechanism. Besides financial sanctions, he is favourable to taking voting rights in the Council away from countries which are not respecting the budgetary discipline agreed by their peers. He calls for a restructuring mechanism for public debt involving private sector participation. "Countries in financial difficulties can't expect that the Community will assist them unconditionally...........Participation by the private sector should be a central element of the Mechanism". Schaeuble: "monetary union was never conceived as a means of enriching financial speculators; neither is it a system for financial transfers from the richer to the poorer countries". In the context of revising the Treaty, the report says that Berlin wants to attach to "the no bail out clause" – the English expression is used – a mechanism for restructuring which would not leave the holders of private bonds, notably banks and insurance companies, indemnified. Schaeuble apparently also availed of the opportunity offered by his visit to Paris to sing the praises of "the German economic model".

http://www.lefigaro.fr/conjoncture/2010/11/02/04016-20101102ARTFIG00659-zone-euro-berlin-veut-faire-payer-le-prive.php

A separate article in Le Figaro Economie is headed "Ireland, Portugal, Greece: costs of borrowing take off". The report says that Trichet's fears are being realised. Gilles Moec, an economist at Deutsche Bank, says "the market is thinking like Trichet: it hates uncertainty". Ireland's ten year bonds yesterday reached 7.22%, the highest level since it joined the Eurozone. "Even if Ireland and Portugal were already worrying the markets for the past two months because of their dangerous budgetary situation, investors were reacting in particular to the risk of debt restructuring in the countries of the Eurozone". Another article in Le Figaro reports on a study by Markit on growth rates in Europe. "The diagnosis is nuanced. It reveals in effect a Europe of different speeds, with important disparities depending on the particular country. Growth rates in manufacturing are improving in Germany, in Italy, in Spain, in the Netherlands, in Austria and in Ireland.

Weblinks not available

Paris Press summary, 1st November

1. Outcome of European Council

On Saturday, Le Figaro's headline was "*Economic Governance: Merkel and Sarkozy relaunch Europe*". The report says that the 27 are agreed on " *a limited revision of the*

Lisbon Treaty"..........and "*Pandora's box risks being re-opened*". In a separate report on prospects for the EU budget, Le Figaro writes that "*Paris, Rome and Berlin had rejected the idea of suppressing direct aids to farmers in the framework of the CAP*". The editorial in Saturday's Figaro sees the Eurozone as going in the right direction but anticipates difficulties when it come to revising the Lisbon Treaty: "***it's hard to see the Irish – already quite suspicious – putting their heads on the block in ratifying a text of which they could be among the first victims***". Liberation (Jean Quatremer in Brussels) heads its report "*the 27 swallow the Deauville deal*" (i.e. the outcome of the recent Sarkozy-Merkel meeting). The report says that Merkel explained that she was forced by her country's Constitutional Court to insist on a revision of the Treaty. Le Parisien talks of re-opening Pandora's box.

Le Figaro Economie (Jacques Mével in Brussels) this morning says that ECB President Trichet is concerned about plans to revise the Lisbon Treaty and fears a negative reaction from the markets for sovereign debt. "*The devil is in the detail and after the agreement in principle arrived at with some difficulty in Brussels last Friday, the 27 are faced with a choice which is already causing division: what's the place of the law of the market in the new rescue mechanism for Eurozone countries threatened with bankruptcy?*". Merkel and Trichet are in opposing camps. What was agreed for Athens can't become the practice. Merkel's tough line was supported by France and Netherlands. Trichet's tough line caused surprise. What's the explanation? "*Announcing that restructuring is just around the corner could dissuade private investors, set off interest rates and* ***worsen the burden of countries like Greece and Ireland***". The report concludes "*just as the ECB is trying to disengage from buying up government bonds, Trichet's problems are increasing*".

SPREADS FOR PERIPHERALS

Spread	4.45pm	11.45am	10am	03-Nov	02-Nov	01-Nov	29-Oct	28-Oct	27-Oct
Greece	899	865	852	851	843	833	821	794	794
Portugal	434	416	411	396	386	372	348	345	340
Ireland	546	532	526	512	492	477	447	436	429
Spain	195	191	186	186	182	177	170	164	161
Italy	154	147	145	147	144	141	136	133	133
Bund yield	238	248	248	243	247	248	253	257	257

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21 November 2010

Mr Olli Rehn
Commissioner on Economic and Monetary Affairs
European Commission

Mr Dominique Strauss-Kahn
Managing Director
IMF

Mr Jean-Claude Trichet
President
European Central Bank

Dear Sirs,

On behalf of the Irish Authorities, I am writing to formally apply for financial assistance in the context of a joint EU-IMF programme. The external assistance sought is made under the terms of the European Financial Stabilisation Mechanism, the European Financial Stability Facility and the IMF assistance programme.

I welcome the statement by the Eurogroup and ECOFIN Ministers which concurred with the EU Commission and the ECB that providing assistance to Ireland is warranted to safeguard financial stability in the EU and in the euro area.

The Irish Authorities will cooperate fully in the preparation of the joint EU-IMF programme of assistance to the Irish State that will now be required to be developed.

Yours faithfully,

Brian Lenihan

Brian Lenihan TD
Minister for Finance

cc Mr Jean-Claude Juncker, Eurogroup President
Mr Didier Reynders, European Union Presidency

An Roinn Airgeadais
Department of Finance

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21 November 2010

Mr Jean-Claude Juncker
Eurogroup President

Mr Didier Reynders
European Union Presidency

Dear Sirs,

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Yours faithfully,

Brian Lenihan

Brian Lenihan TD
Minister for Finance

cc Mr Olli Rehn, Commissioner on Economic and Monetary Affairs, European Commission
Mr Dominique Strauss-Kahn, Managing Director, IMF
Mr Jean-Claude Trichet, President, European Central Bank

An Roinn Airgeadais
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21 November 2010

M. Jean-Claude Trichet
President
European Central Bank
Kaiserstrasse 29
60311 Frankfurt am Main
Germany

Dear Jean-Claude

I refer to your letter of 19 November 2010.

First, let me say that I fully understand your concerns and that of the Governing Council in regard to the implications of the current situation of the Irish banking system. As you know, Ireland has worked very aggressively, and to the limits of our fiscal capacity, to protect and repair the banking system in the light of the dangers to financial stability both in Ireland and Europe.

For example, in September 2008 the Government introduced an extensive Bank Guarantee to seek to bolster the funding difficulties of the banks by providing a Sovereign guarantee of bank liabilities. This was quickly followed by a bank recapitalisation programme announced in December 2008 and nationalisation of Anglo Irish Bank in January 2009. The establishment of NAMA was announced in April 2009 to remove the riskiest land and property development loans from the banks' balance sheets. At this stage, Ireland has provided or pledged some €32 billion of capital to the banking system.

These extensive set of measures have been taken in tandem with a most extensive programme of fiscal adjustment, amounting to some €15 billion of discretionary fiscal consolidation in 2009 and 2010 so far, with a further adjustment of another €15 billion planned by 2014. Measures for 2011 alone will amount to over €6 billion. Thus, Ireland has proved so far to be flexible and aggressive in dealing with its problems and will continue to be so.

These assertive measures, contributed to a substantial improvement in international sentiment towards Ireland and a partial recovery in the banks' funding position in the first quarter of 2010. The new Financial Regulator announced the results of his PCAR exercise and required the banks to meet it by the end of the year. The banks successfully commenced the process of accessing longer-term funding to manage the large redemptions cliff due in September. Reliance on bank funding from the Eurosystem was reduced. In addition, Bank of Ireland initiated and ultimately successfully completed its private capital raising exercise.

However it was not possible to sustain the improvement in the banking environment. As the year progressed there were a number of developments which led to a sharp reversal in financial conditions, of which the following are just some.

- Following the onset of the Greek debt crisis during April, international markets became increasingly concerned regarding Ireland's fiscal position, the strength of the Bank Guarantee and the fiscal capacity of the State to stand behind the banks.
- There was a slowdown in the pace of economic recovery nationally and increasing concern regarding the speed of recovery in the international economy particularly in the USA.
- Credit rating actions and negative market sentiment exacerbated the situation
- Uncertainty about the status of bondholders in the event of access to external support added to instability
- These events led to a crisis of confidence in both the Irish banking system and increasingly the Irish Sovereign. As a result, our banks, as you know so well, have had to turn to ECB/Central Bank funding to replace their market funding especially in September when a large number of bonds which matured under the two year Credit Institutions Financial Support (CIFS) Guarantee became due.

In order to seek to reverse these trends, I made a further comprehensive and detailed further Statement on Banking at the end of September and outlined the actions being taken to provide certainty to the international markets on the scale of bank losses. The Statement covered changes to NAMA to accelerate loan transfers and provide visibility on the final discounts expected to arise, the revised assessment of the capital positions of the banks on the basis of final expected NAMA discounts and the projected maximum capital requirements for Anglo Irish Bank.

While initially this information was initially well received, the credibility of projected bank loan losses was increasingly called into question by analysts and investors – there comes a point at which negative sentiment starts to feed on itself, even independently of underlying realities, and we are clearly at that point.

In relation to points (1) to (4) of your letter, I would like to inform you that the Irish Government has decided today to seek access to external support from the European and international support mechanisms. This grave and serious decision has been taken in the light of the developments I have outlined above and informed by your recent communications, and the advice you have conveyed to me personally and courteously in recent days.

The Government is clear, in the light of the very intensive and productive work done by Irish, European Commission, IMF and of course ECB officials, in recent days, that there is a potential programme which will be both workable and effective and which will incorporate real and significant restructuring measures in relation to the financial sector, structural reforms and fiscal consolidation, and the Government is committed to this. Indeed, your officials in Dublin have had the opportunity to see a draft of our proposed four year plan, so you may be aware that our fiscal and economic programme is in fact very extensive, and forms an appropriate basis for programme discussions.

It is also clear from the discussions over recent days that any programme will include provision for further capitalisation on a scale which should convince markets that capital is not a problem. I was very pleased to note that the intensive examination of the Irish authorities' work on capital requirements has not indicated any new and unanticipated 'hole' in the banks' capital position, and it would be helpful if this is made clear in internal and external communications. However, the fact is that the market has not accepted the current capital levels as adequate, so more must be done.

In relation to your fourth point, there are already such arrangements in place in respect of each bank in receipt of ELA which provide the assurances that you call for.

I hope that this will provide some reassurance to the Governing Council and that you will be able to reiterate in a public way the continuing practical support of the ECB for the liquidity position of the Irish banks, to help to reassure the market on this crucial point.

You know that we here will not be lacking in the will to do all that is necessary on our part to protect our economy and people and to play our role in the Eurosystem.

Yours sincerely

Brian Lenihan

Brian Lenihan, TD
Minister for Finance

Government Statement

Announcement of joint EU - IMF Programme for Ireland

The Government today agreed in principle to the provision of €85 billion of financial support to Ireland by Member States of the European Union through the European Financial Stability Fund (EFSF) and the European Financial Stability Mechanism; bilateral loans from the UK, Sweden and Denmark; and the International Monetary Fund's (IMF) Extended Fund Facility (EFF) on the basis of specified conditions.

The State's contribution to the €85 billion facility will be €17½ billion, which will come from the National Pension Reserve Fund (NPRF) and other domestic cash resources. This means that the extent of the external assistance will be reduced to €67½ billion.

The purpose of the external financial support is to return our economy to sustainable growth and to ensure that we have a properly functioning healthy banking system.

The external support will be broken down as follows: €22½ billion from the European Financial Stability Mechanism (EFSM); €22½ billion from the International Monetary Fund (IMF); and €22½ billion from the European Financial Stability Fund (EFSF) and bilateral loans. The bilateral loans will be subject to the same conditionality as provided by the programme.

The facility will include up to €35 billion to support the banking system; €10 billion for the immediate recapitalisation and the remaining €25 billion will be provided on a contingency basis. Up to €50 billion to cover the financing of the State. The funds in the facility will be drawn down as necessary, although the amount will depend on the capital requirements of the financial system and NTMA bond issuances during the programme period.

If drawn down in total today, the combined annual average interest rate would be of the order of 5.8% per annum. The rate will vary according to the timing of the drawdown and market conditions.

The assistance of our EU partners and the IMF has been required because of the present high yields on Irish bonds, which have curtailed the State's ability to borrow. Without this external support, the State would not be able to raise the funds required to pay for key public services for our citizens and to provide a functioning banking system to support economic activity. This support is also needed to safeguard financial stability in the euro area and the EU as a whole.

Programme for Support

The Programme for Support has been agreed with the EU Commission and the International Monetary Fund, in liaison with the European Central Bank. The Programme builds on the bank rescue policies that have been implemented by the Irish Government over the past two and a half years and on the recently announced National Recovery Plan. Details of the measures are set out in the accompanying Notes for Editors.

The Programme lays out a detailed timetable for the implementation of the measures contained in the National Recovery Plan.

The conditions governing the Programme will be set out in the Memorandum of Understanding and the Government will work closely with the various bodies to ensure that these conditions are met. The funding will be provided in quarterly tranches on the achievement of agreed quarterly targets.

The Programme has two parts – the first part deals with bank restructuring and reorganisation and the second part deals with fiscal policy and structural reform. The requirement for quarterly progress reports covers both parts of the programme. When the documentation on the Programme is finalised, it will be laid before the Houses of the Oireachtas.

Bank Restructuring and Reorganisation

The Programme for the Recovery of the Banking System will be an intensification of the measures already adopted by the Government. The programme provides for a fundamental downsizing and reorganisation of the banking sector so it is proportionate to the size of the economy. It will be capitalised to the highest international standards, and in a position to return to normal market sources of funding.

Fiscal Policy and Structural Reform

The Ecofin has acknowledged the EU Commission's analysis that a further year may be required to achieve the 3% deficit target. This analysis is based on a more cautious growth outlook in 2011 and 2012 and the need to service the cost of additional bank recapitalisations envisaged under the programme. The Council has today extended the time frame by 1 year to 2015.

The Programme endorses the Irish Government's budgetary adjustment Plan of €15 billion over the next four years, and the commitment for a substantial €6 billion frontloading of this plan in 2011. The details of the Programme closely reflects the key objectives set out in the National Recovery Plan published last week. The adjustment will be made up of €10 billion in expenditure savings and €5 billion in taxes.

The Programme endorses the structural reforms contained in the Plan which will underpin a return to sustainable economic growth over the coming years.

The Government welcomes the support shown to Ireland by our Eurozone partners and in particular by the United Kingdom, Sweden and Denmark who have expressed their willingness to offer bilateral assistance. The Government also welcomes the assistance of the IMF.

As part of the Programme, Ireland will discontinue its financial assistance to the Loan Facility to Greece. This commitment would have amounted to approximately €1 billion up to the period to mid-2013.

28th November 2010

Statement by Minister for Finance, Brian Lenihan T.D. on the EU/IMF Programme for Ireland and the National Recovery Plan 2011 to 2014

A Cheann Comhairle, amid the sometimes hysterical and contradictory reaction to the external assistance programme on which the Government concluded agreement last weekend, one quintessential point has been overlooked. It is this: without this Programme, our ability to fund the payments to social welfare recipients, the salaries of our nurses, our doctors, our teachers, our Gardai, would have been extraordinarily limited and highly uncertain.

Fifty billion of the €67.5 billion we are receiving from our European partners and from the IMF will go to fund those vital public services over the next three years. In those circumstances, the only responsible course of action for any government was to accept the EU/IMF financial assistance fund.

Nonetheless, we enter this Programme not as a delinquent State that has lost fiscal control. We enter it as a country that is funded until the middle of next year; as a State whose citizens have shown remarkable resilience and flexibility over the last two years in facing head on, an economic and financial crisis the severity of which has few modern parallels internationally.

The team with whom we have negotiated has acknowledged our success in stabilising our public finances and they have endorsed our banking strategy. They have also accepted our four year Plan for National Recovery and have built their prescribed Programme around that Plan.

This needs to be emphasised because it shows that we do have the capacity to get out of our difficulties and that we have already made considerable progress in that respect. The fact is our economy is showing signs of recovery. As I have already reminded this house last week

- GDP will record a very small increase this year based on strong export growth.
- Exports are expected to grow by about 6% in real terms this year, driven by improvements in competitiveness and a strengthening of international markets.
- Conditions in the labour market are also beginning to stabilise.

The outlook for next year is much improved. As forecast in the Plan growth is expected to be around 1 ¾ per cent next year again driven by a remarkably robust export performance.

The Fine Gael leader referred to the European Commission's less optimistic forecasts in the Dail yesterday which he suggested had undermined our Four Year Plan. He ignored the substantial upward revision of the Commission's forecast on international trade which will benefit a small open economy like ours in which growth, by common consent, will be export led.

It is also the case that, under the Programme, we have been given an extra year to reach the deficit target of 3% of GDP precisely to take account of the Commission's lower growth forecast. I welcome this step but it does not alter our budgetary plans as set out in the Plan. In other words the target of €15 billion of adjustments by 2014, remains but there is further room for manoeuvre in the event that growth is lower than expected. In the later years, the Commission's growth forecasts are similar to my Department's. It is also the case that others - such as the ESRI for example - believe that the Department of Finance forecast is too pessimistic.

The Programme has adopted in its entirety the measures set out in the National Recovery Plan as a roadmap to return our economy to sustainable growth. The adjustment of €15 billion by 2014 has been accepted as has the breakdown of €10 billion in spending reductions and €5 billion in revenue raising measures. The details of the first €6 billion of this adjustment will be contained in the budget which I will present to the House next Tuesday.

The programme of structural and labour market reform aimed at improving our competitiveness has also been endorsed by the Programme. It set out a detailed quarterly schedule for the achievement of the agreed measures.

The negotiations on the Programme which took place over a ten day period were intense and at times difficult. They were conducted under my direction and that of the Governor of the Central Bank by the most senior officials from my Department, the Central Bank and the Financial Regulator, the National Treasury Management Agency and the Office of the Attorney General.

There has been the usual barrage of criticism of the outcome accompanied by the personal abuse of those involved that has become common place in our debased public discourse. But none of the critics explains how we could have secured the funds we require at less cost to the State.

Indeed the arguments put forward have been patently wrong. For example, it has been claimed that we are paying a higher interest rate than Greece even though Greece is now seeking our terms. The interest on Greek loans is 5.2% for 3 year loans. Ireland's interest rate will be 5.8% for loans that are on average for 7½ years. A basic fact of sovereign borrowing is that the longer a country borrows money, the higher the interest rate paid.
Germany can borrow at 2½% but the remainder of the EU member states are borrowing at either far closer to 5% or higher than 5% and they must cover their costs.

Of course, if at any time during the three years of the Programme, it emerges that we could borrow at a lower rate in the markets, there is nothing to stop us from doing so.

I want to clarify the position of the €85 billion funding package and its impact on our debt levels. Of the total, €50 billion is to provide the normal budget financing: in other words, it is money we would have had to borrow over the next three years in any event. The Programme provides these funds at a much lower rate than currently available to us in the market. This level of funding is already included in the plan. Of the remaining €35 billion - €10 billion is for immediate additional bank recapitalisation and the remaining €25 billion is to be used as a contingency fund, only to be drawn down if required

Furthermore, the State is in the happy position of being able to contribute €17.5 billion towards the €85 billion from its own resources, including the National Pension Reserve Fund. It can do this without prejudicing the commitments in the four year plan to use funds from the NPRF for projects such as the water metering programme and retrofitting.

This use of the NPRF has provoked the most bewildering criticism of all from parties who, having for years fundamentally disagreed with the very existence of the Fund, have now become its most ardent protectors. And on this point the arguments make absolutely no sense. Why would we borrow expensively to invest in our banks when we have money in a cash deposit earning a low rate of interest? And how on earth can we ask tax payers in other countries to contribute to a financial support package while we hold a sovereign wealth fund? We have a large problem with our banks which has forced us to seek this external assistance. In these circumstances, it is surely appropriate that our cash reserves should be deployed to help solve that problem.

The reason we had to seek external assistance is because the problems in our banking system simply became too big for this State to handle on its own. Our public finance problems are serious but we were well on the way to solving them. The combination of the two sets of difficulties in circumstances where the entire Eurozone was under pressure was beyond our capacity.

So the primary aim of the Programme agreed last weekend is to support the recovery and restructuring of our banking system.

It has been clear for some time that our banks were facing serious challenges in terms of their liquidity position. Lingering concerns in the market regarding their capital position led to negative market sentiment.

This was despite the substantial transfer of the banks' riskiest loans to NAMA and the detailed capital adequacy assessment made by the Financial Regulator in the summer as well as the significant recapitalisation measures that flowed from that.

But the Programme does not propose any departure from existing policy: its prescription is an intensification and acceleration of the restructuring process already being undertaken for the Irish banks. A key objective is to ensure that the size of the domestic banking system is proportionate to the size of the economy and is appropriately aligned with the funding capacity of the banks overall taking into account stable sources of deposit and wholesale funding.

The programme also seeks to demonstrate the capacity of the banks to accommodate very significant further deterioration in asset quality so as to rebuild market confidence in the robustness and financial resilience of the banking system overall.

The Central Bank is requiring the banks to meet a Core Tier 1 capital ratio of 12% - a key measure of capital strength. If the banks cannot source it themselves, the State will inject the necessary capital. For that purpose, €10bn can be drawn down immediately from the overall Programme fund. A further remaining 25 billion euro will be available on a contingency basis.

The Central Bank will also carry out an updated capital assessment exercise or PCAR review of the capital position of the banks in early 2011 based on stringent stress testing and detailed reviews of asset quality and valuation. This exercise will ensure that over the coming years, the banks' capital ratio do not fall below 10.5% - this is a high standard in international terms and should give significant confidence to the market that our banks will be in a strong financial position. This in turn will provide the necessary reassurance to allow the banks to attract greater market funding in due course.

The Government will also undertake a process of significant restructuring and right-sizing of the banks to reduce their balance sheets. In this context, all land and development loans below €20m in Bank of Ireland and AIB will be transferred to NAMA.

Further work will be undertaken in the short-term with the banks to identify how the sector can be reorganised to ensure that we have a viable and financially strong banking system which meets the needs of the real economy and has the confidence of international markets. This strategy, developed in collaboration with the various international organisations and endorsed by them, builds on the measures adopted by the Government over the past two years to resolve our serious banking difficulties.

The Programme allows for an integrated approach to the restructuring of Anglo Irish bank and Irish Nationwide Building Society, building on the proposed Asset Recovery Bank structure to seek to maximise value from their loan books.
Revised restructuring plans for the two institutions will be submitted to the European Commission in early 2011 detailing the resolution of the institutions, in particular the arrangements for working out of assets over an extended period of time

I would like to reiterate that all deposits held with the domestic banking system are safe and covered by the Deposit Protection Scheme for sums up to €100,000. In addition, deposits are covered under the Eligible Liabilities Guarantee Scheme for sums over €100,000 for the full term of the deposit up to five years providing they are made prior to 30 June 2011.

There has been much commentary about the need for senior bondholders to accept their share of the burden of this crisis. I certainly raised this matter in the course of the negotiations and the unanimous view of the ECB and the Commission was and is that no Programme would be possible if it were intended by us to dishonour senior debt. The strongly held belief among our European partners is that any move to impose burden sharing on this group of investors would have an enormous ripple effect throughout the Euro system. That was confirmed by Professor

Honohan in an interview last Monday when he said there was no enthusiasm in Europe for this course of action.

There is simply no way that this country, whose banks are so dependent on international investors, can unilaterally renege on senior bondholders against the wishes of the ECB. Those who think we could do so are living in fantasy land. Worse still, those who know we cannot do so but who nonetheless persist with the line are damaging this country and its financial system: and all for the sake of a cheap headline. It is a case of politics as usual even at this most difficult time.

It is estimated that around 84% of Ireland's bonds are held by international investors. Whether guaranteed by the State or not, a decision to default on these bond obligations would seriously compromise the standing of the whole of the Irish financial system. That is the advice of the Governor of the Central Bank; that is the advice of the National Treasury Management Agency; that is the advice of the Attorney General.

The idea that is out there that somehow there are no costs associated with default is entirely incorrect. Ireland is hugely dependent on Foreign Direct Investment. These companies have large funds and investments in Ireland and directly and indirectly employ a quarter of million people in this economy. Any default on senior debt and the uncertainty that would cause would undoubtedly impact on the future investment decisions of these companies.

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Subordinate Bonds

Subordinated debt holders are in a different position. As I said in my statement on the 30th of September last, there will be significant burden sharing by junior debt holders in Irish Nationwide and Anglo Irish Bank. These two institutions had received very substantial amounts of State assistance and it was only right that this should be done.

My Department has been working with the Office of the Attorney General to draft appropriate legislation to achieve this and this is near finalisation. Parallel to this Anglo Irish Bank has run a buyback operation which will offer these bondholders an exchange of new debt for old but at a discount of 80%. This process is still underway and will be concluded shortly.

Obviously this approach will also have to be considered in other situations where an institution receives substantial and significant State assistance in terms of capital provided to maintain their solvency ratios. I hope to be in a position soon to announce this legislation.

We need a properly functioning banking system for this country. As I have indicated in the past we need to shift to a banking system commensurate with the economy but one that is strong and capable of meeting our needs. That has been the overriding objective of all our efforts since this crisis began two years ago. I believe the considerable funds provided by this Programme, will enable us to bring this crisis to an

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end and to secure the future of the Irish banking system so that it can play its full role in supporting the development of this country.

Conclusion:

We have been through a traumatic two years. Of course, we would have preferred to avoid resort to external assistance. But we can emerge from it a stronger and fitter economy. The attributes that brought us the boom: the quality of our workers, our entrepreneurship, our pro-business environment; all of these remain in tact. During the boom we built a top class transport infrastructure, sport and cultural facilities and educational sector. Over the last two years, we have won back much of the competitiveness we lost during the boom.

This 3 year EU/IMF Programme will provide the basis for funding us through our current difficulties. It provides the funding to restructure and recapitalise our banking system. And it will guide us through the implementation of the necessary budgetary and reform strategies set out in the National Recovery Plan. A Cheann Comhairle, we have every reason to be confident about the future of this economy.

An Roinn Airgeadais
Department of Finance

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Dublin, 3 December, 2010

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, DC 20431

Dear Mr. Strauss-Kahn:

1. Ireland faces an economic crisis without parallel in its recent history. The problems of low growth, doubts about fiscal sustainability, and a fragile banking sector are now feeding on each other, undermining confidence. To break this vicious circle, we are proposing a strong, wide-ranging, reform programme, backed by a substantial international financing package, to restore confidence and return the economy to a path of sustained growth and job creation.

2. At the root of the problem is a domestic banking system, which at its peak was five times the size of the economy, and now is under severe pressure. The Irish owned banks were much larger than the size of the economy. The fragility of the banking sector is undermining Ireland's hard-earned economic credibility and adding a severe burden to acute public finance challenges. Decisive actions to restore the strength of the financial sector and re-establish fiscal credibility are needed now.

3. The Irish authorities have already undertaken major steps to address these challenges. For the financial sector, these include measures to facilitate funding of banks, separate good assets from bad, asset disposals, and bank recapitalisation. On the fiscal side, we have pursued a large consolidation programme since 2008 and have announced a National Recovery Plan that accelerates the process of putting public finances on a sound footing.

4. But we recognise that more needs to be done. A fundamental downsizing and reorganisation of our banking system is essential. We are immediately undertaking several bold measures to achieve a robust, smaller, and better capitalised banking system that will effectively serve the needs of the economy. Restoring the banks to viability will also help insulate public finances from further pressures. We are mindful that the transition to a healthy banking sector will need to be actively managed to avoid fire sales of assets and

reduce market uncertainty. We are, therefore, expeditiously raising capital standards, stepping up efforts that will ensure that banks' losses are promptly recognised, and creating a mechanism to inject needed capital into the banks. We are also strengthening the banking resolution framework to promote financial stability.

5. In addition, we are also pressing ahead with our commitment to achieving a sustainable budget position. The National Recovery Plan lays out our strategy for staying the course of needed reform in a way that is socially fair and protects the most vulnerable. Recognising that Ireland already has put in place a business-friendly environment, our Plan also lays out a range of structural reforms that will be implemented to underpin economic stability, and enhance growth and job creation.

6. We are turning to our international partners for support as we implement these far-reaching objectives. Our estimate is that the financing need would be up to €85 billion until the end of 2013. We therefore request that the Fund support our policy programme through an arrangement under the Extended Fund Facility which can be drawn over a period of 36 months in the amount of SDR 19.4658 billion (€22.5 billion). This arrangement, along with support of €45 billion from the European Financial Stability Mechanism/European Financial Stability Facility including bilateral loans from the United Kingdom, Sweden and Denmark, and the judicious use of our own resources (€17.5 billion), will help ensure financial stability as we restore market confidence and return to durable growth.

7. The attached Memorandum of Economic and Financial Policies outline the economic and financial policies that the Irish authorities will implement during the remainder of 2010 and the period 2011–13. We are confident that the policies set forth in this memorandum are adequate to achieve the objectives under the programme. We stand ready to take any corrective actions that may become appropriate for this purpose as circumstances change. As is standard under Fund-supported programmes, we will consult with the Fund on the adoption of such actions in advance of necessary revision of policies contained in this letter.

8. This letter is being copied to Messrs. Juncker, Reynders, Rehn, and Trichet.

Sincerely,

Brian Lenihan

Brian Lenihan
Minister for Finance

Patrick Honohan

Patrick Honohan
Governor of the Central Bank of Ireland

National Treasury Management Agency

Mr Brian Lenihan TD
Minister for Finance
Government Buildings
Upper Merrion Street
Dublin 2

28 November 2010

Dear Minister

I refer to my letter of 27 November 2010 regarding the proposed programme of external financial assistance and the subsequent discussion on it at last night's Government meeting at which I was in attendance. I am writing, as requested, to elaborate on a number of issues which arose.

I learnt during the course of the discussion that the external authorities and the European Central Bank (at board or equivalent level) had taken the view that burden sharing with unguaranteed bank senior bond holders was "not on the table". It is unfortunate that, notwithstanding the fast moving pace of recent events, I was not made aware of this outcome.

Recognising that burden sharing involving unguaranteed bank senior bond holders is no longer a potential cost mitigant, it is all the more important that the costs to the State of recapitalising the banks are kept to the minimum consistent with restoring a viable banking system. In this context I referred last night to the need to manage carefully the pace of deleveraging the banks' balance sheets so as to limit drawings on the €35 billion bank capital contingency.

As indicated in my letter, the NTMA is of the view that the estimated average cost of the facility, at 5.8%, is not unreasonable. The rates underlying that average are based on long standing IMF formulae and precedent lending. The estimated average rate is comparable with the 6.02% paid on Ireland's most recent Government bond auction (September 2010) which was for an 8 year maturity. Our credit rating has, of course, moved down sharply since that auction.

As I also indicated in my letter, the NTMA accepts that the adoption of the programme is the best course of action. I would, however, emphasise again the immediate need for a clear statement from the ECB underpinning ongoing liquidity support for the Irish banks if the programme is to succeed.

Yours sincerely

John C. Corrigan

John C. Corrigan
Chief Executive

Treasury Building, Grand Canal Street, Dublin 2, Ireland. Telephone: (353 1) 664 0800 Fax: (353 1) 664 0890 e-mail: info@ntma.ie

Minister
From: Michael J. McGrath

Impact of Promissory Notes on the Public Finances in Cash & Accounting Terms

1. You raised with me the issue of the impact of the Promissory Notes committed to Anglo Irish Bank, INBS and EBS on the public finances, both in cash and accounting terms.

2. As you know, just under €31 billion has been committed to be provided to these financial institutions in the form of Promissory Notes so far in 2010. The amounts committed to each institution, the various issues dates and the applicable interest rates (see paragraphs 8 -10) are as follows:

Table 1 – Value, Issue Dates & Interest Rates on Promissory Notes Issued in 2010

€m		
Anglo	Issue Date	Interest Rate
€8,300	31 Mar 2010	4.1745%
€2,000	28 May 2010	4.5693%
€8,580	23 Aug 2010	5.1316%
€6,400	Before end-year	6.4% approx*
€25,280		
INBS		
€2,600	31 Mar 2010	4.1745%
€2,700	Before end-year	6.4% approx*
€5,300		
EBS		
€250	17 Jun 2010	5.4634%

*Will depend on Irish Government 10 year bond yield at time of issue

3. The Promissory Note issued to Anglo Irish Bank in March has been increased on two separate occasions and a further increase of €6.4 billion, as outlined in the 30th September Statement on banking, is imminent. It was also outlined in that Statement that the Promissory Note issued to INBS in March will, in the very near future, be increased by an additional €2.7 billion.

4. This full amount of just under €31 billion is included in the headline General Government deficit measure for 2010, as are the €100 million Special Investment Shares in both INBS and EBS. This means that the headline General Government Deficit for 2010 is currently estimated at 32% of GDP. On an underlying basis, it is estimated at 11.9% of GDP, broadly in line with the Budget day target.

5. It is currently assumed that 10% of the total value of the Promissory Notes (or just over €3 billion) is drawn down each year, beginning in 2011, and paid in cash to the financial institutions. While these payments do not impact on the General Government Deficit (as the total value of the Notes is included in the 2010

deficit), the principal payments must be funded by borrowings. Debt interest costs on cash borrowings of €3 billion next year are currently estimated at about €200 million and this debt interest cost impacts on the General Government Balance. The cumulative interest costs on the cash borrowings will increase as the further €3 billion in cash payments are made each year.

6. The first full cash payments of the Anglo Irish Bank and INBS moneys are due to be paid on 31st March 2011, the anniversary of the issue date of the first €8.3 billion Promissory Note instalment committed to Anglo and €2.6 billion to INBS. The first cash drawdown of the EBS money is due on the 17th June 2011.

Accounting Treatment

7. Also included in the General Government deficit measure for 2010 is accrued interest on the Promissory Notes. As you might recall from the BSM, there is an interest coupon attached to these Promissory Notes. This is necessary to allow these institutions "fair value" the Note at face value in their accounts for capital purposes.

8. While the Government has committed to giving cash of €31 billion to these three institutions in equal instalments over the next number of years, the institutions are now showing the full value of the Promissory Notes in their accounts for capital adequacy purposes. As the actual cash is not being paid upfront to the institutions, interest must be paid so that the institutions can value the Notes at par on their accounts. The terms of the Promissory Notes allow interest to be rolled up and paid after the principal sums have been repaid. Although the interest will not be paid on the due dates, and will instead be rolled up over the life of the Promissory Note, under General Government accounting rules, the amounts payable must be accrued into the year in which they are due, and will therefore impact upon the General Government deficit. It is currently estimated that the interest which must be accrued into 2010 is just over €700 million. The exact issue date of the most recent increases to Anglo Irish Bank and INBS and the precise interest rates will determine the exact amount of interest to be accrued.

9. Interest began to accrue on the Notes issued on the 31st March from that date. Interest is therefore accruing on the full value of those Notes for the period 31 March – 31 December in 2010 and for the period from 1 January to 30 March in 2011. Once the first 10% cash drawdown is made, interest then accrues on the outstanding balance of the capital sum plus the rolled up interest for the remainder of 2011 and the first 3 months of the 2012. This continues until the principal sum and rolled up interest payments have been paid down in full. This will be some time in the middle of the next decade.

10. Table 2 in the Appendix details the impact, on the Exchequer and General Government Balances of the principal payments and the interest accruals over the 2010 – 2014 forecast period.

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xx October 2010

cc Secretary General, Mr. O'Brien, Ms. Nolan, Mr. Beausang, Mr. Ahearne, Mr. Keane, Mr. O'Leary

APPENDIX

Table 2 – Impact of Promissory Notes & SIS on the Public Finances 2010-2014

	2010	2011	2012	2013	2014
Impact on GGB:					
Capital	€31.03bn				
Pro Notes	*€30.83bn*				
Special Investment Shares (SIS)	*€200m*				
Accrued Interest	€0.7bn	€1.5bn	€1.4bn	€1.3bn	€1.2bn
Annual debt interest costs on cash borrowings of c. €3 billion*		€200m	€200m	€200m	€200m
Total as a % of GDP	*20%*	*1%*	*0.9%*	*0.8%*	*0.7%*
Impact on Exchequer:					
SIS	€200m				
Principal Payments		c. €3b	c. €3b	c. €3b	c. €3b
Annual debt interest costs on cash borrowings of c. €3 billion		€200m	€200m	€200m	€200m

**based on current interest rate*