TUARASCÁIL ón gComhchoiste Fiosrúcháin i dtaobh na Géarchéime Baincéireachta

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

REPORT of the Joint Committee of Inquiry into the Banking Crisis

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

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

Dept. of Taoiseach
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January 2016

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THEME: R1

Effectiveness of the regulatory, supervisory and governmental regime structure

LINE OF INQUIRY: R1a

Appropriateness of the regulatory regime

Summary of Main Recommendations by Chapter

Chapter 3: Range of Financial Service Providers to be Overseen by the SRA

- Given that the Government had decided, in principle, that a Single Regulatory Authority for financial services should be established, the Group considered that all financial service providers should, in principle, be dealt with by the SRA and that a compelling case would have to be made for the exclusion of any provider from its remit. The recommendations of the Group in relation to the range of financial providers to be overseen by the SRA are summarised in Appendix I. In particular, a statutory position of Registrar of Credit Unions should be established within the SRA.

Chapter 4: Roles & Functions of the SRA

- The Minister for Finance should be responsible for the SRA.
- All prudential supervision, including decisions concerning licensing and authorisation, of financial services should be assigned to the SRA.
- The SRA should be given statutory responsibility for consumer issues related to the entities for which it is to be responsible.
- A statutory position of Customer Protection Director should be established within the SRA.
- Two panels, representative of consumer and industry interests, respectively, and chaired by high ranking officials of the SRA, should be established.
- The Deposit Guarantee and Investor Compensation Schemes should be operated by the SRA.
- A single statutory ombudsman scheme for all financial services provided by regulated entities, to operate independently of the SRA, should be established.

Chapter 5: E-Commerce and Financial Services

- The SRA should adopt a proactive approach to relevant developments in the e-commerce area so that Ireland is well-placed in Europe as a location for such business.
- The SRA should be given a role in raising public awareness of the potential risks involved in accessing financial services web sites.
- The SRA should be cognisant of developments at EU level and the recommendations of the International Organisation of Securities Commissions.
- The SRA should ensure that it is fully conversant with the information available and the issues arising so that it can pursue, and make an effective contribution to the development of, appropriate strategies and actions, including any necessary legislation for this area.

Chapter 6: Structure and Location of the SRA

- The Group's recommendation is that the SRA should be an entirely new independent organisation. A minority of the Group prefers to locate the SRA within a restructured Central Bank.

- The SRA should have a public interest Board, the non-executive members of which should be selected for their experience of legal, financial, consumer issues, etc.

- The Board should comprise nine members, six of whom, including the Chairman, should be appointed by the Minister for Finance, following consultation with the Minister for Enterprise, Trade and Employment. The Board should also include the Chief Executive Officer, the Customer Protection Director and the Secretary General of the Department of Finance.

- The Chief Executive Officer of the SRA should be appointed by the Board of the SRA, for a fixed term, with the consent of the Minister for Finance, following an open competition conducted by an appropriate independent body. The person appointed should be responsible, under the SRA's Board, for the implementation of functions in relation to prudential regulation and consumer protection.

- A high-level Standing Committee should be established by statute which would be chaired by the Department of Finance and be composed of representatives of the Central Bank and the SRA, the purpose of which would be to ensure the maximum degree of co-operation and information disclosure between the SRA and the Central Bank.

- Arrangements to provide for Ministerial and Parliamentary accountability are also proposed.

Chapter 7: Arrangements for the Imposition of Sanctions and Penalties on Regulated Entities

- The SRA should have power to impose sanctions on a financial services provider for breach of the relevant regulatory code. In the event of the provider expressly accepting the determination and sanction, the same would be binding on the parties.

- An independent disciplinary Tribunal should be established to make determinations and impose sanctions in instances where financial services providers do not accept a determination by the SRA and to review decisions taken by the SRA in relation to licensing conditions.

- The financial services provider should be entitled to appeal against the determination of the Tribunal and/or the sanction imposed to the High Court.

- Should the financial services providers neither appeal the determination of the Tribunal nor indicate its acceptance of the determination and/or sanction, the SRA should be entitled to apply to the High Court ex parte seeking confirmation of the determination and/or sanction.

Chapter 8: Funding Staffing and Resourcing

- The SRA should be funded by industry. However, the funding structure used should incorporate sufficient and appropriate safeguards to ensure that costs imposed on individual bodies are fair having regard to the nature and extent of services being provided.

- The competitiveness of the financial services industry should not be undermined by the charges imposed. This applies both to the competitive position of financial services entities relative to each other and to the competitiveness of the financial services industry internationally.

- There should be consultation with the industry in relation to the determination of fee structures.

- Arrangements for funding in the transitional phase are also proposed.

- The staff required by the SRA should, to the maximum extent possible, be recruited from amongst the staff currently involved in regulation.

- The SRA should have full autonomy in relation to the staffing arrangements, including recruitment and remuneration, applicable in its area. The Group noted that the implications of this recommendation for overall public pay policy would have to be taken into account.

- The detailed arrangements concerning staffing should only be settled following full consultation between the various organisations concerned and the representatives of the staff involved.

- The Group also makes recommendations in relation to financial accountability.

Chapter 9: Legislation Required and Timeframe for Establishment

- The SRA should be established as quickly as possible but should not begin its operations without the necessary statutory powers to effectively fulfil its remit being in place. In order to meet these objectives, it should be established on a statutory basis through the minimum legislation necessary to achieve that objective.

- Initially, the existing statutory basis for regulation should be maintained and amending legislation should transfer responsibility for its execution to the SRA.

- The Group considers that the establishment of the SRA could be realistically achieved within one year of a Government decision to proceed.

- As soon as possible after the establishment of the SRA, legislation should be enacted to consolidate all the statutory provisions related to the SRA.

Chapter 1

Background to Establishment of Implementation Advisory Group

Background

1.1. On 20 October, 1998 the Government agreed in principle to the establishment of a single regulatory authority for the financial services sector at the earliest date possible; and agreed to the immediate establishment of an Implementation Advisory Group to progress the necessary work.

Membership

1.2. The membership of the Group was as follows:

Chairman:

Mr Michael McDowell,	Senior Counsel

Other Members:

Mr Liam Barron,	Deputy Director General and Secretary, Central Bank of Ireland,
Mr Tom Considine,	Assistant Secretary, Department of Finance,
Mr John Corcoran,	Assistant Secretary, Department of Enterprise, Trade & Employment,
Ms Carmel Foley,	Director of Consumer Affairs,
Mr Roger Kenny,	Second Legal Assistant, Office of the Attorney General,
Mr Dermot McCarthy,	Assistant Secretary, Department of the Taoiseach,
Mr Joe Moran,	Former Chief Executive, ESB,
Mr Maurice Tempany,	Former President, Institute of Chartered Accountants in Ireland.

Secretary to the Group:

Mr Jim O'Brien,	Director, Department of Finance.

Terms of reference

1.3. The Implementation Group was set up to advise the Government on:

a) The role and functions of the single financial regulatory authority (e.g. prudential supervision, the maintenance of orderly markets, safeguarding of clients' funds, consumer protection, the development and regulation of conduct of business rules), including consideration of the issues arising from combining the functions of monetary policy and prudential regulation.

b) The range of financial service providers to be overseen by the authority (e.g. banks, building societies, Post Office Savings Bank, insurance companies and brokers, investment intermediaries (including lawyers and accountants in as much as they handle clients' funds), exchanges, credit unions, friendly societies, finance companies, moneylenders, etc.) also taking account of the development of electronic commerce which may involve new types of service providers.

c) The extent to which, if any, existing regulators (e.g., the Director of Consumer Affairs, Registrar of Friendly Societies, Central Bank and Department of Enterprise, Trade and Employment) would continue to have functions in relation to the regulation of the financial services sector and the extent to which any alteration to the *status quo* would impinge on the non-regulatory functions of the Central Bank.

d) The organisational structure for the authority, including the manner of its public accountability.

e) The funding, resourcing and staffing of the authority (and issues arising in a transition to a new structure, including staffing and industrial relations, and the extent to which the authority could be self-financing).

f) The legislative changes necessary for the establishment of the authority.

g) The time schedule (including, insofar as necessary, a phased implementation) for achieving the objective of a fully operational single financial regulator at the earliest date possible.

Work of the Group

1.4. The Group was originally due to report to the Tánaiste and Minister for Enterprise, Trade & Employment and the Minister for Finance before the end of February 1999. However, due to the complexity of the subject matter, the number of submissions received and the number of meetings with interested parties, the Government extended the report date for the Group. In the period since the Group was set up in November 1998, it held 22 meetings and received submissions from 64 interested parties, particularly in response to an advertisement placed in the main national daily newspapers in November, 1998, inviting submissions. In particular, the Group met with representatives of the staff currently employed in the area of financial services supervision. A copy of the advertisement is attached at Appendix IV and a list of the those who made submissions to the Group is attached at Appendix V.

1.5. The Group also met with a representative of the UK Treasury and with a representative of the UK Financial Services Authority. The Group took account of the Report of the Joint Oireachtas Committee on Finance and the Public Service on the regulation and supervision of financial institutions (July 1998). The situation in other countries was examined (see Appendix III) and the views of all the relevant interested parties who made submissions to the Group and those who met the Group were carefully considered. Account was also taken of the analysis undertaken by the Working Group on Banking and Consumer Issues established by the Minister for Finance in April 1998 the remit of which was overtaken by the establishment of the Implementation Advisory Group.

1.6. The Group also noted that the terms of reference of the Moriarty Tribunal include a remit to make whatever broad recommendations the Tribunal considers necessary or expedient for enhancing the role and performance of the Central Bank as regulator of the banks and of the financial services sector generally. However, as the Tribunal had not reported before the conclusion of the Group's work, the Group was not in a position to take account of any work which the Tribunal may have undertaken in relation to this matter.

1.7. The Report contains a considerable amount of material detailing aspects of the financial services industry and the associated regulatory framework. This material has been prepared on the basis of submissions made to the Group and other material supplied. The Group has endeavoured to ensure that the material is as comprehensive and as accurate as possible and that it gives a fair representation of the existing situation. **However, it wishes to stress that the Report should not be regarded as a legal interpretation of the relevant legislation.**

THEME: R1

Effectiveness of the regulatory, supervisory and governmental regime structure

LINE OF INQUIRY: R1b

Effectiveness and appropriateness of the supervision policy and powers

Direction Number 4

Department of Finance reporting structures and communications channels for the period

2001 to 2010

a. Central Bank of Ireland

Following the passing of the Central Bank and Financial Services Authority of Ireland Act 2003, the Central Bank of Ireland was re-structured and re-named as the Central Bank and Financial Services Authority of Ireland. Under this Act the supervision of all financial institutions operating in Ireland was consolidated under an autonomous body - the Irish Financial Services Regulatory Authority (IFSRA) - which was established within the Central Bank.

Since the financial crisis a whole series of reforms have been introduced to underpin a more effective and efficient financial regulatory regime. The Central Bank Reform Act 2010 created a single fully-integrated Central Bank of Ireland with a unitary board – the Central Bank Commission – chaired by the Governor of the Central Bank. The unitary Central Bank structure gives the Commission members a more complete remit over prudential regulation and financial stability issues. The Central Bank Reform Act 2010 also gave effect to significant structural changes in the operation of financial regulation in Ireland which, inter alia, provided for the dissolution of the IFSRA.

The Central Bank is now a single fully-integrated structure with the unitary Board responsible for the stability of the financial system overall, for prudential regulation of financial institutions and for the protection of consumer interests. The Governor of the Central Bank remains solely responsible for European System of Central Banks (ESCB) related functions.

The Central Bank operates independently of the Department of Finance and the Minister has no role in day-to-day operations of the Central Bank. Nevertheless, the Department of Finance enjoys a close working relationship with the Central Bank. Officials at all levels are in regular contact at domestic and European level across a wide range of financial services and regulatory issues.

Formal Reporting structures post 2010 Central Bank Reform Act

The Central Bank Reform Act 2010 enhanced accountability, oversight and reporting mechanisms through a number of measures including the following.

- Annual Performance Statements on regulatory performance are prepared by the Central Bank, presented to the Minister for Finance and laid before the Houses of the Oireachtas. The performance statement is to be in the form, and is to relate to matters, that the Minister directs, with the exception of the exercise by the Governor of his functions under the ESCB Statute. A committee of the Oireachtas may call the Governor and/or the Deputy Governors to be examined on the Performance Statement.

- Annual Report (accounts) is prepared by the Central Bank each year. The statement of accounts is to be in such form as approved by the Minister for Finance, and on approval by the Comptroller and Auditor General, is laid before the Houses of the Oireachtas.

- A Strategic Plan is prepared by the Central Bank at least every three years. The Minister for Finance may request the form in which the Strategic Plan is prepared. The Strategic Plan is laid before the Houses of the Oireachtas by the Minister for Finance.

- A Statement of Income and Expenditure (Budget) is prepared by the Central Bank and submitted to the Minister for Finance. Any subvention by the Central Bank to cover an estimated shortfall in income from levies and fees is approved by the Minister for Finance.

- At least every four years, the Central Bank is to arrange for either another Central Bank or another person or body certified by the Governor, after consultation with the Minister for Finance, to carry out an international peer review of the Central Bank on the performance of its regulatory functions.

- The 2010 Act confers on the Central Bank the power, with the approval of the Minister for Finance, to make regulations prescribing an annual Industry Funding Levy to be paid by regulated financial service providers to the Central Bank. The purpose of this levy is to fund or partly fund the cost of the annual budget for financial regulation.

- The Central Bank (Supervision and Enforcement) Act 2013 enables the Central Bank to make regulations across a number of areas including consumer protection, client assets, account switching and related party lending. Before making regulations under section 48 of the 2013 Act, the Central Bank is required to consult with the Minister for Finance and for that purpose shall provide to the Minister a draft of the proposed Regulations

- The Secretary General of the Department of Finance is an ex-officio member of the Central Bank Commission.

<u>Formal Reporting Structures Pre 2010 Central Bank Reform Act</u>

Prior to 2010 and the passing of the Central Bank Reform Act, reporting structures and mechanisms between the Central Bank and the Minister/Department were on a less formal footing apart from formal legislative requirements around the Annual Report, Statement of Income and Expenditure and Industry Levies.

In addition, prior to the 2010 Act, the Secretary General of the Department of Finance was a member of the Board of Directors of the Central Bank, and the Minister for Finance, after consulting the Minister for Enterprise, Trade and Employment, appointed between 6 and 8 members to the Irish Financial Services Regulatory Authority.

Please also refer to Direction Number 23-28 inclusive in relation to the Domestic Standing Group and Principals Group.

b. Committees of the Oireachtas including but not limited to the Finance Committee

The Department of Finance would have attended various Dáil Committees principally the Public Account Committee and the Finance Committee. These are discussed as follows;

Public Account Committee

The Committee Secretariat issued the draft upcoming monthly programme to the Government Accounting section. This was issued to internal votes/sections who had responsibility for any of the items listed and informed Government Accounting Section of same. Government Accounting then notified the Secretariat of the Public Accounts Committee. Where attendance was required, briefing remained the responsibility for the section/vote in question. Where business items related to other Government Departments, D/Finance officials attended.

Committee on Finance (at that time)

Requests came from the Secretariat for the Committee on Finance to the Central Votes Section. Central Vote Section coordinated attendance and requested briefings. Where attendance was required, briefing remained the responsibility for the relevant section who also nominate those officials attending.

c. Cabinet

Each Government Department wrote to the Minister for Finance in relation to Government memoranda requiring input by the Department. The Minister's Office circulated draft memoranda to relevant sections. Once observation issued from the sections were cleared by the Ministers, the individual sections contacted the relevant Government Departments to communicate observations.

With the introduction of eCabinet contact between the Department of Finance and the Government Secretariat through eCabinet resided with the Estimates Office – Central Section. The Estimates Office distributed, coordinated and returned responses through eCabinet/Government Secretariat.

d. Oireachtas

Questions raised by Deputies relating to Public Affairs connected with this Department were received by the Estimates Office – Central Section for distribution, coordination and return of replies via the Minister's Office.

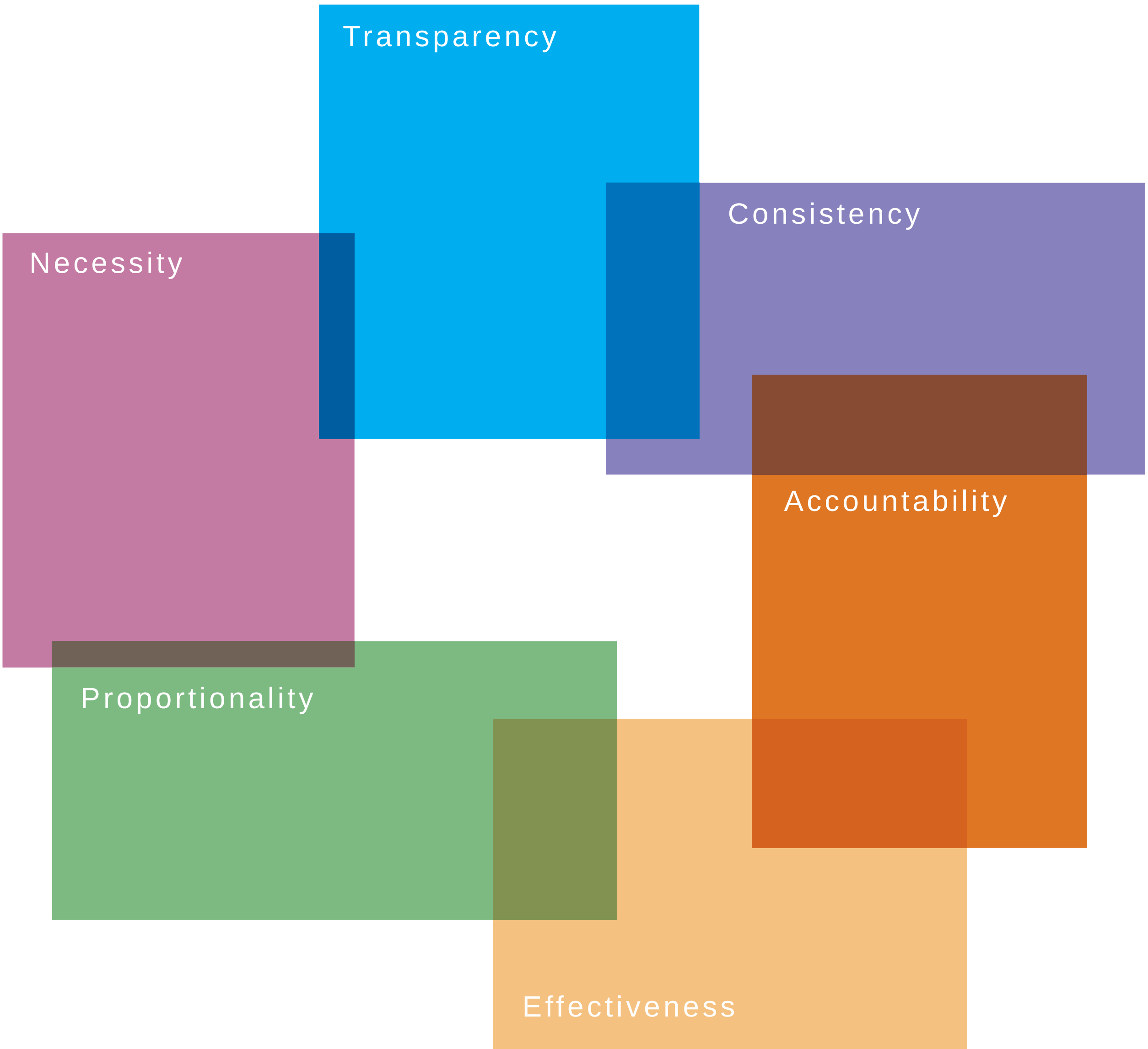
Department of Finance

January 2015.

Roinn an Taoisigh
Department of the Taoiseach

Regulating Better

A Government White Paper setting out six principles of Better Regulation



Roinn an Taoisigh
Department of the Taoiseach

Regulating Better

BAILE ÁTHA CLIATH
ARNA FHOILSIÚ AG OIFIG AN tSOLÁTHAIR
Le ceannach díreach ón
OIFIG DHÍOLTA FOILSEACHÁN RIALTAIS
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Taoiseach's Foreword

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

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

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

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

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

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

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

BERTIE AHERN, T.D.
Taoiseach

Executive Summary

Introduction

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

Principles

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

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

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

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

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

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

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

Approach taken

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

Overview of Actions

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Next steps

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

Regulatory Strategy

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

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

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

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

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

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

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

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

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

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

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

JOINT COMMITTEE OF INQUIRY INTO THE BANKING CRISIS

WITNESS STATEMENT: KEVIN CARDIFF

Introduction

The Joint Committee has directed me, pursuant to section 67(1) of the Houses of the Oireachtas (Inquiries, Privileges and Procedures) Act 2013, to provide a written statement on 23 separate lines of inquiry which cover a vast array of topics and which span a significant period of time. I am pleased to have this opportunity to discuss the events of the financial crisis in Ireland: I was very involved in many of the key events of this time and I have endeavoured in this short statement to address the relevant lines of inquiry. However, there is no way for me to deal with several years of intense activity in a short statement. Therefore, to help the inquiry, I will simply note that I have already given testimony at a number of Oireachtas committees over recent years, of which I am sure the inquiry is fully aware, and have provided many important documents already (details at Appendix 1). I will try not to go over old ground in this statement and also will try to manage the legal restrictions that have been placed on witnesses here, in relation to ongoing legal cases where I might well be called as a witness. In order to support the work of the Committee as far as I can, I have prepared a lengthy report for the Committee as an appendix to this summary document, dealing with just some of the key periods of the crisis in significant detail (Appendix 2).

I have been asked to address the various lines of inquiry as they relate to my role as Former Secretary General of the Department of Finance ("DoF"), and any other relevant roles that I held within the DoF. I joined the Department of the Public Service, later subsumed into the Department of Finance in 1984. I was appointed as head of the Division with responsibilities encompassing the Department's role in relation to financial services matters in December 2006. I was appointed as Secretary General in February 2010 and remained in that role until February 2012.

I have divided this statement into three parts. Part I addresses the events leading up to and including the bank guarantee decision taken by the Government on 30th September 2008. Part II addresses the domestic and international policy responses following the bank guarantee. Part III provides a more general overview of the role of the Department of Finance during the crisis, and its interaction with other institutions such as the Central Bank ("CB"), Financial Regulator ("FR") and the National Treasury Management Agency ("NTMA").[1]

[1] Lines of Inquiry C1, C2, C3 and R4 are addressed in Part I. Lines of Inquiry C4, C5, C6, C7 and R4 are addressed in Part II. Lines of Inquiry R1, R3, R4 and R5 are addressed in Part III.

Part I – Events Leading up to the Bank Guarantee

Genesis of the broad guarantee

When Northern Rock started to dissolve in the Autumn of 2007, there was a very public run on that bank. There were large queues at its branches, including in Dublin. The crisis was addressed by the UK government initially in two ways – by nationalising the entity, and by providing a guarantee. The extent of that guarantee was – in the course of midnight phone calls with the British authorities – clarified so that Irish depositors would know that they too would be safe.

The lessons of Northern Rock were closely noticed, and perhaps 'over-learnt' in Ireland. While government guarantees carry real risks for taxpayers and citizens, a guarantee of a financial institution is a fast and effective way to stop a bank run and protect savers and the economy. Nationalisation on its own, despite all the reassurance that the involvement of the State might provide, does not stop a bank run.

Towards the end of 2007, the Department of Finance (DoF) and the Central Bank, including the Financial Regulator (CB/FR), engaged in a carefully constructed simulation exercise to see how one might react in the event of a bank crisis. In this simulation exercise – which dealt with a situation of one bank in trouble in isolation – the action recommended by those parties playing the CB/FR was that the Government should provide a guarantee. Those playing the Government were more reluctant to rely on the transfer of risks to Government in this way. One key lesson, therefore, was that one should not jump too quickly for a guarantee approach, and should insist on a broader consideration of options.

This consideration was also discussed and indeed agreed with CB/FR, and as liquidity for the banking system gradually tightened during 2008, crisis management discussions looked also at other intervention options, and there was a real consciousness of the necessity to avoid knee-jerk guarantee responses. For example, during this time the two larger banks, while not involved in any planning exercise, were nonetheless approached by the Governor of the Central Bank, who suggested to them that in the event of a potential failure of any of the smaller institutions, they might need to be part of the solution to such an event. I understood from the Governor that indeed the two larger banks understood that such an event could threaten the system that sustained them and that they had indicated – hypothetically of course, since there was no case in point – that they would engage and try to play their part.[2]

Other intervention approaches were also considered and worked upon, while at the same time there was a lot of effort in CB/FR, the DoF, the NTMA and the banks themselves, with a view to ensuring that ongoing liquidity pressures could be addressed – various key papers outlining the development of various crisis resolution options during 2007 and the first half of 2008 have already been provided to the Oireachtas and published – links at Appendix 1. It was understood that in some other countries banks were being encouraged to repatriate funds so as to provide liquidity in their own domestic markets and the CB/FR was naturally encouraging Irish institutions also to be willing to share their liquidity with each other. This much is well known and I will go no further on this point, for the legal reasons explained earlier.

In the first half of 2008, there was absolutely no serious consideration, which I can now recall, being given in CB/FR, DoF or NTMA to a broad guarantee in respect of a wide range of institutions for a wide range of liabilities, as a discrete policy option, although of course, as I have just noted, there was

[2] I should note at this point that in the first half of September 2008, when it was clear that INBS was in significant difficulty, I told the staff in the FR that Bank of Ireland ("BOI") and Allied Irish Banks ("AIB") would have to be called in to assist in a resolution for INBS. The CB/FR met with the two banks and got a strong refusal – the banks were concerned that INBS' very high property exposure would be difficult for them to digest. Goldman Sachs produced an assessment when asked by the FR– based of course on information from INBS and its executives – as well as from documentary review, of the scale of difficulties with the INBS loan book. The assessment was perhaps a bit more upbeat than we had feared at the time, and in retrospect and with all the benefit of hindsight was hopelessly optimistic. On Sunday 21 September 2008, I heard their assessment in a meeting with Basil Geoghegan from Goldman Sachs and various others: while it might be difficult to get 100% back on some of the loans they had issued, there was nothing to suggest any losses could not be absorbed by INBS' own capital. In other words, they seemed to be in some trouble, would need some help, but were probably solvent.

ongoing work on legislative options which included consideration of how to enable Government to give guarantees in appropriate cases. But at various points in time it seems that a broad Government guarantee did feature in discussions in other quarters. The Governor of the Central Bank, I believe, received approaches in March/April 2008 suggesting that the Government should announce a broad guarantee – though it is possible that what was in mind at this time was a general political undertaking rather than a formal guarantee. While those approaches probably reflected particular pressures around and just after St Patrick's Day 2008, I believe the concept persisted in some form for some time after, and was raised in certain discussions with the Department of Finance, and perhaps also with the Central Bank in Summer 2008, but I am not aware of any extensive discussion between the Department and other parties on this concept at this point in time

The Committee is well aware of the liquidity crisis that gripped the banking sector in September 2008, and I have described in detail the events of that month in Appendix 2. At that point, a range of interventions in the banking sector were being considered, including the nationalisation of INBS as a measure to stem the institution's liquidity drain. However, when Lehmans filed for bankruptcy on 15th September 2008, the liquidity situation became critical and there was widespread panic in the financial markets and among the general public.

The decision taken by the Government on 20th September 2008 to increase the level of protection for bank deposits from €30,000 to €100,000 worked well to assuage the concern among individual depositors and avoided a run on INBS.[3] However, that measure was almost worthless to bigger depositors whose sentiment towards Irish banks could change overnight. Nobody involved with the decision expected anything other than a short respite, a little time to continue working and planning.

[3] Most of INBS' deposits came from smaller depositors and thus the increase in the deposit guarantee eased the liquidity pressure on that institution.

In September 2008, in light of these domestic and international developments, a broad guarantee was discussed extensively, and quite properly, as one of the options available to Government in dealing with the crisis that had by then arisen.

Naturally, the broad guarantee concept, as an option to be considered, was discussed between CB/FR, NTMA and DoF on a number of occasions – Dr Somers, the CEO of NTMA, for example, was personally consulted, informally, in the first half of September 2008 on such an option, and both the Central Bank and the NTMA were asked at various points in time to consider what the implications of such an approach would be. The broad guarantee approach was also discussed in crisis-management meetings including various different formations of the DoF, CB/FR, NTMA, various advisers and Ministers in the days and weeks leading up to the guarantee night.

A broad guarantee approach was also suggested to officials on a number of occasions by individuals/organisations in the private sector, before the guarantee night itself, and my records suggest that this list may have included Bank of Ireland. I do not believe that these external approaches were influential in relation to the crisis preparation work being carried out by various working groups involving the DoF, NTMA, CB/FR and their advisers. So far as I can recall, a broad legal guarantee was never proposed by DoF or NTMA, or any of the professional advisers we dealt with, in the period before the night of 29/30 September 2008 (guarantee night), but it was discussed as an option. CB/FR were also not initially to the fore in pressing for a broad legal guarantee, with the Governor suggesting on 18 September that it might be counterproductive, but by the guarantee night, the Central Bank and the FR representatives were clearly and explicitly in favour of that approach, having regard to the situation at the time.

It will also be recalled that there was a government meeting on 28 September – as I understand it, one, or perhaps two, Government ministers since have said that the decision to opt for a broad guarantee approach was made at that meeting. If that had been the case, it would have been very important to communicate the decision to the technical teams involved. However, there was no such message, no-one said on the guarantee night that the decision had been made the day before, and the disposition of the Minister for Finance that night would not suggest that any final decision had been made. However, it seemed clear that the Taoiseach did have a predisposition in favour of the broad guarantee approach, and I cannot know if this was influenced by the previous day's Government meeting. There had been a short note prepared for use by the Minister for Finance at that Government meeting, which does not suggest that a detailed discussion was expected, or that a broad guarantee would be the outcome. These matters, and the events of the guarantee night itself, are dealt with in considerably more detail in the report I have provided as Appendix 2

The Night of the Guarantee

The inquiry may find it useful for me to set out my recollections of the night of 29/30 September and I will do so in summary here.

I was surprised that the option of giving a broad guarantee for the banking system emerged very early in the discussion which commenced sometime after 6 p.m. that night. I had expected of course that we would discuss guarantees for banks among the options for consideration that evening – indeed, by then I thought that some guarantees were inevitable. But the Taoiseach raised the issue of a broad pre-emptive guarantee quite early in the discussion. It seemed to me that this was going to be the baseline approach against which every other option would be considered.

There was a lengthy discussion of the situation and the options, especially the guarantee option[4]. Tony Grimes of the Central Bank spoke about the funding position of the banks. John Hurley, the Central Bank Governor explained his understanding of the ECB and the European position (outlined below). The Irish central bankers were clear that their own balance sheet was not large enough to make large loans to Irish banks outside the framework of the European System of Central Banks. They had been very insistent on the need to have Government funds available to lend to banks. CB/FR representatives all strongly favoured the broad guarantee approach.

The Minister for Finance and I were more cautious about the broad guarantee option, noting that on its own it could not solve all the problems of the banks, and indicating that other options should be considered, including nationalisation of Anglo.

The financial regulator spoke about the current solvency situation of the banks, maintaining the position that they were solvent, if not without difficulties.

At some stage in the evening, the Minister's views moved more towards the consensus favouring the broad guarantee option. The Minister told me some time later that during a pause in the meeting, when he and the Taoiseach had left the room to speak privately, he agreed with the Taoiseach to follow the broad guarantee approach. He did not use the word 'overruled' but rather indicated that he thought it important that he and the Taoiseach presented a common political position. I was not in that private discussion and had no other insight into itat the time. However, the Taoiseach and the Minister did not actually announce that their decision was made, but rather let the meeting move toward their position.

[4] A document outlining pros and cons of a variety of options had been presented by Merrill Lynch on the previous Friday, and legislation and practical arrangements had been prepared to allow for a variety of intervention options was ready, including nationalisation, special liquidity swap arrangements, direct loans, guarantees etc. This legislation could have been passed in a matter of days. Moreover, practical arrangements had been made (e.g. preparation of contracts, availability of collateral) to ensure that any decision to support the banks by loans or swaps could be implemented more or less immediately. Extensive work had been done on the State Aid implications of the various options, so that a State Aid notification could be made, also immediately.

While all of this had been going on, Dermot Gleeson and Eugene Sheehy, the Chairman and Chief Executive of AIB, and Richard Burrows and Brian Goggin, ‘Governor’ and CEO of Bank of Ireland, were waiting in a separate conference room. They were asked to join the meeting.

The bankers’ message was stark.

We already knew they were in trouble, of course, and it was clear that Anglo was entirely out of cash and that Irish Life would most likely be in the same boat later that week. The two large banks reported that market participants were no longer differentiating between Irish banks - all were being tarred with the same brush, and all would have funding problems. On their estimates, although both had substantial liquidity cushions, the circumstances were so extreme that even these two most substantial Irish banks might run out of funds in a matter of a small number of weeks. They wanted a guarantee from the Government in very broad terms, and they wanted insulation and differentiation from, in particular, Anglo, which they argued could come from a nationalisation of that bank.

While at this stage INBS was draining funds only slowly, it would eventually also have difficulties, and the EBS building society which had not yet been flashing the same warning signals as the others, would presumably also be infected. All the main domestic credit institutions, therefore, were likely to run out of cash in time frames running from days to weeks, assuming that the situation did not worsen. A worrying situation had become a desperate situation in just a few short days.

The bankers came in, discussed, left, and then were invited back into the room for further discussion. I took some notes, scribbled in a hardback notebook and I understand the Committee has a transcript – I have recently, for the first time in some years, seen a pdf of the original manuscript, and have provided a new transcript as a note to the report at Appendix 2, though it should be said that these were never intended to amount to a formal minute. Based on my memory and these notes, the following is clear to me:

- The banks outlined the market position, as I have noted above.[5]
- They asked that Anglo be nationalised.
- They explicitly sought a very broad guarantee, and provided a suggested wording.
- I asked, for the benefit of the room, why we should guarantee existing long-term borrowings of the banks, and they responded in terms of ensuring a consistent message to the market, avoiding market differentiation, the negative reaction that would arise if existing lenders to banks were disadvantaged compared to new, pointing out that addressing the funding situation as it stood would require that existing lenders would also be new lenders.
- Similar arguments arose in relation to subordinated debt, but I do not recall now if the bankers made a distinction between dated and undated subordinated debt.
- There was a discussion of how much the banks ought to pay the Government for a guarantee, and Eugene Sheehy suggested a risk-adjusted system on the model of the American FDIC charging system.[6]

It has emerged in the media and testimony to the inquiry in recent times that Sean Fitzpatrick had been to visit at least one of these two banks that day, and had asked that the larger bank would take over Anglo. I do not recall this rather salient piece of information being passed on in the meeting with the Taoiseach.

[5] even the word "bankruptcy" was used, but this was a reference to the possibility that they would have no cash to meet payments, rather than that they would be insolvent in the sense of the value of their assets failing to match their liabilities.

[6] The FDIC is the Federal Deposit Insurance Corporation. A decision on charging mechanisms was not made that night, and was instead considered in the following days.

While the bankers' interventions had added some additional colour to our understanding of the situation, their information was consistent with that already available, rather than adding much new (apart from confirming their own fears).

In fact, theirs was not even a worst-case scenario. In the absence of significant official intervention, a failure of Anglo to meet any of its obligations would trigger events of default on many of its borrowings, so billions of euro would become payable immediately. Anglo's depositors would lose access to their money, the bank would close its doors. Depositors, large and small, could rush to take funds from the other banks, and international investors would withdraw from Ireland as much as they could. Payment systems, such as international credit card and debit card service providers might withdraw services from their Irish customers abroad and internationally traded businesses would face in many cases impossible demands for upfront payments for goods and services and could no longer rely on their bank guarantees and working capital facilities, as the Irish banks would not have the cash to honour them.

The contagion effect of an Anglo default could be exacerbated by the failure within the same week of ILP, and it was possible that all banks would be told to close their doors for days or weeks while authorities struggled to cope.

In relation to bonds of various types, the meeting accepted the bankers' arguments that it was important to keep the bondholders on board, and covered by the guarantee, so as to encourage the flow of new funds. (This may in retrospect have been a mistake, but not as great a mistake as is sometimes suggested, as only a minority of these bonds would mature in the two year period concerned.)

The term – or length of time applicable – for the guarantee was also discussed, and it was considered that two years ought to be enough, or that if problems persisted for longer, then other mechanisms would have been found to address issues in the meanwhile.

And there was a relatively short discussion, too, about the question of whether to include dated subordinated debt within the guarantee. I was asked whether that issue had been covered in any of the discussions with the Merrill Lynch team, and I reported that at the meeting of 26 September they had advocated – on balance – that dated subordinated debt would have the same protections as senior debt, and so dated subordinate debt was included.

Although one of the more junior people in the room, I spoke a number of times. I can remember in particular a number of interventions I made:

1. I noted, being aware of their views and also having emailed Merrill Lynch as soon as it became clear that a broad guarantee approach would be a key focus of discussion, that Merrills and NTMA, our advisors, would be likely to advise against the broad guarantee option, on balance.
2. I said, in response to a direct question, that I thought that immediate nationalisation of Anglo, with guarantees as required for that institution, but only a strong political declaration in relation to support for the others, was a better option in my opinion.
3. I pointed out, that while the Financial Regulator was happy to say the institutions were solvent, it was clear that once guaranteed they could not in any circumstance be allowed to fail – and so any capital or cash shortfall would have to be addressed: there would be no choice in the matter. We knew that our advisors had concerns about the business models of at least two institutions and that a deterioration in the banks' loan books was possible – however there was no inkling of

the sheer scale of later loan losses and there was no suggestion made at any stage that the banks were, at that moment, insolvent.

4. I stressed, repeatedly, the necessity to make the guarantee as legally watertight as possible and this meant swift legislation and immediate engagement with the European Commission – the guarantee would not work if not accepted in the market and it was therefore important that no market players or significant government or EU authorities would call it into question.[7]
5. After the decision had been made in principle, I was asked to produce drafts of the final announcement, based on the banks' wording – I believed that this wording was broader in a number of respects than had been understood by the official parties and I told the Taoiseach in a side conversation that if we accepted their wording the banks 'would be laughing at us' or words to that effect – the Taoiseach immediately asked me to ensure the draft reflected the understanding of the official parties as to the decision taken, rather than the banks' draft.

My interventions described above got varying amounts of support/rebuff, and of course I was only one of several people making comments on the various options proposed. However, the Taoiseach was clearly in charge, as was quite appropriate.

What is clear is that none of the options available to the Government on the guarantee night were pleasant, or sure to be sufficient to address the immediate crisis. The broad guarantee approach was a legitimate option in the circumstances. Its pros and cons had been laid out in a document prepared on 26 September, and while the 'cons' were substantial, there were important advantages. The various

[7] On one of my later interventions on this point, Minister Lenihan, possibly thinking I was overplaying my concerns, asked who would wish to challenge the guarantee – I replied that any of the market participants who were to be excluded from the protection of the guarantee might decide it was to their advantage to be troublesome: on this I was correct, as we discovered quite quickly.

meetings and considerations that took place in the weeks before the guarantee note are, again, set out in greater detail in the report at Appendix 2.

Contacts with the ECB before the guarantee night

Since it has been a matter of some discussion in the inquiry to date, and since I may be able to add to the Committee's understanding of matters, I will deal briefly with official contacts with the ECB in the days and weeks leading up to the guarantee night. There was a real concern that the ECB should be kept 'in the loop', in part for reasons of good cooperation, but also for the purposes of having some insight into what was going on in Europe. There was a fear that multiple phone calls to member state government or regulatory authorities would not provide much information but might prompt regulatory authorities in other countries to tell their institutions to pull funds out of Ireland.[8] It seemed safer to use the Central Bank's links with the European Central Bank to get information on what was going on – and indeed this approach did provide some useful intelligence on, for example, Fortis, Depfa/HRE and so forth. It was also necessary that the Central Bank should be in touch with the ECB because we needed to know what level of support we could expect from the ECB in the event of difficulties in Irish institutions. It was my understanding that the ECB was therefore aware of increasing difficulties in Ireland and that the ECB and Mr Trichet personally were aware on the 28 September 2008 that the Irish banks had real difficulties that could materialise in a very short number of days – my recollection is that before the guarantee night, the Governor of the Central Bank, John Hurley reported three important points from Frankfurt, after discussions with the President of the ECB:

[8] This was not an empty fear – in months that followed, when it was clear that Ireland did have some problems, we heard through the banks that some of their foreign counterparts had been encouraged to think again before depositing with Irish institutions. Of course, this is not the sort of thing that can be proved, but it seemed credible, and there were some more formal actions that seemed to confirm this threat.

1. There was no European approach to the financial crisis in preparation at that point.
2. The message from the President of the ECB was that each Government should protect its own financial institutions and should not let them fail.
3. The ECB was not preparing any special intervention in relation to liquidity, including in relation to collateral.[9]

The discussions on the guarantee night therefore took place in a situation where there was a vacuum at the European level, not yet filled, and where the message from the ECB was, more or less, save your banks yourselves. Records I have seen recently confirm that Mr Tony Grimes, Director General of the Central Bank, spoke with the ECB about our situation and about collateral rules in or around the 17th of September and that the Governor was expected to make efforts to speak to Mr Trichet in or around the 28th September, and did in fact speak with him, and these records are consistent with my recollection of events. I know that the late Brian Lenihan has given an account of a message left on his telephone from Mr Trichet or his office. I was not aware of that at the time, so far as I can recall, but it seemed clear at the time that the message Mr Trichet had for the Irish Government was the one being passed via the Central Bank Governor: that it was very important that Governments prevent their banks from failing, and that there was no concerted European initiative in prospect.

It is entirely possible that a different approach to the Irish financial sector difficulties might have been taken, and more efforts would have been made to make contact with European partners, if there was any sign of a concerted approach being prepared. That there was not such a concerted approach was not, of course, particularly the fault of the ECB

However, despite there being no special intervention by the ECB aimed at the Irish situation, Irish banks were able to avail of a range of ECB facilities, over the period of the crisis, some of which had indeed

[9] In fact the ECB was moving in the opposite direction, towards tighter collateral rules, having taken some loss on Lehmans

[6] **Note of meeting of 21 September 2008**

10

Note of Meeting with Goldman Sachs, 21 September 2008 (Sunday)

DSG	KC, CH, BO'H, MO'D (for part), PN (for part)
Goldman Sachs:	Geoghegan + 1

Basic points

- Have examined INBS top 30 loans Ireland and top 30 loans UK
- Lot of reassurance in those that there is real value there
- But based on management discussions
- Some of book could be securitised for liquidity purposes, but slow job , even with advisers – would need new specialist staff of their own in house
- Riskiest part is not UK but Irish book
- Very few loans above 250m. Irish bank well diversified
- Will be difficult to get 100% recoveries for some loans. UK book – profit sharing ventures in reality – some profit shares will pay this year
- KPMG are looking through a worst case scenario
- So far, could see hits eat through capital, but nothing to suggest it would go further than that
- To provide greater analysis would need a real estate, legal and accounting person
- Auditors do not see performance here being worst than anywhere else
- Management's central case assumption is loss of a few 100m
- Essential to retain knowledge of management.
- Liquidity a big issue – at current rates reaches limits in 11 days, but real danger of acceleration. Loans are assignable (per McCanns) but would take time to package them – work on assets continues
- Convinced help from authorities will be required – soon
- Suggested range of options for discussion with pros and cons (1) Nationalisation (2) Stand alone with liquidity support (3) Break up
- Mark to market value right now maybe 50/60% but lot of value in loans if worked through

30/9/08

T BL AG DMcC KC DD JH E McCague Goggin Burrows Sheehy Gleeson

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Burrows - Rapidly deteriorating situation everywhere
fully caught up in it
Situation threatens the stability of our organisations

Rumour in NYSE that Dublin won't go tomorrow

Contagion from weaker to strong

2 institutions in terminal decline

Why has INBS not been dealt with? Afraid people will assume INBS &

Anglo tied in to the healthier outfits.

Remedial action
2 elements (a) guarantee for surviving
(b) troubled patients to be taken out

Can't guarantee that any guarantee will work

Critically important guarantee should register as sound among Centrals Banks around the world — language must be unmistakeable

Increased difficulty with funding — slight resistance to overnight funding today (heard from Eamonn Hackett, Treasury).

[page break in manuscript notes]

Sheehv - on positive side, retail guarantee has been very successful — no effect on wholesale depositors.

Trend has been increasing — more and more difficult "no quote for Dublin".

People we've been dealing with for decades pulling back — 1 month we will be funding bank overnight. But if can't even get that, disaster — bankruptcy.

Market is saying that Anglo is bust.

Guarantee in xxxx will not help equity markets, but may help liquidity a bit.

Want price to be in cash.

10 bn
1bn tier 1

BofI 2 billion

[page break in manuscript notes]

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[14] **Text of Government decision taken early in the morning of 30 September 2008**

Government Decision to Safeguard Irish Banking System

The Government has decided to put in place with immediate effect a guarantee arrangement to safeguard all deposits (retail, commercial, institutional and interbank), covered bonds, senior debt and dated subordinated debt (lower tier II), with the following banks: Allied Irish Bank, Bank of Ireland, Anglo Irish Bank, Irish Life and Permanent, Irish Nationwide Building Society and the Educational Building Society and such specific subsidiaries as may be approved by Government following consultation with the Central Bank and the Financial Regulator. It has done so following advice from the Governor of the Central Bank and the Financial Regulator about the impact of the recent international market turmoil on the Irish Banking system. The guarantee is being provided at a charge to the institutions concerned and will be subject to specific terms and conditions so that the taxpayers' interest can be protected. The guarantee will cover all existing aforementioned facilities with these institutions and any new such facilities issued from midnight on 29 September 2008, and will expire at midnight on 28 September 2010.

The decision has been taken by Government to remove any uncertainty on the part of counterparties and customers of the six credit institutions. The Government's objective in taking this decisive action is to maintain financial stability for the benefit of depositors and businesses and is in the best interests of the Irish economy.

The Financial Regulator has advised that all the financial institutions in Ireland will continue to be subject to normal ongoing regulatory requirements.

This very important initiative by the Government is designed to safeguard the Irish financial system and to remedy a serious disturbance in the economy caused by the recent turmoil in the international financial markets.

Ends

Anglo Irish Bank

On the 8th of September last I announced the Government's decision on the restructuring and resolution of Anglo Irish Bank, which remains subject to European Commission approval.

This envisages the splitting of the bank into two licensed and regulated credit institutions: an Asset Recovery Bank focussed on recovering maximum value for the State from the loan assets and business of Anglo not being transferred to NAMA and a Funding Bank to fully safeguard Anglo's deposit base.

I said then that the guaranteed position of depositors in Anglo Irish Bank would be unaffected by the new structural arrangements for the bank. Both existing and future depositors are a critical source of funds for the restructured Anglo and protecting these depositors is a priority.

Capital Assessment – Anglo Irish Bank

Mr Matthew Elderfield and his staff in the Central Bank have worked intensively liaising very closely with the CEO and senior management team in Anglo, NAMA and the other relevant authorities to establish as definitively as possible the level of capital required by the new structure.

This assessment has now been completed. The result has been communicated to the bank and a statement has been issued by the Central Bank. The statement provides an explanation of the approach and methodology adopted to determine the bank's capital requirements.

The Central Bank has, therefore, determined and advised the Bank that in the central - or expected loss case - an additional €6.4bn in total capital will be needed for the Recovery Bank and Funding Bank structure to continue to meet the minimum capital requirements in the coming years consistent with Basel rules.

A total of €22.9bn has already been provided by the State since the bank was nationalised early in 2009. This additional capital requirement brings the projected total gross cost of the restructuring of Anglo Irish Bank to €29.3bn.

This additional capital will be provided by increasing the Promissory Note issued by the State and by appropriate burden-sharing exclusively by holders of Anglo subordinated debt instruments as outlined below.

The Central Bank has carried out a detailed analysis of potential losses in the bank in the coming years. The examination has drawn on comprehensive information and analysis of Anglo's non-NAMA loan book carried out both by the Bank and its advisers and independent consultants in preparing the Bank's Restructuring Plan for the European Commission. Information has also been made available by NAMA from a review of assets securing the loans in Anglo's remaining NAMA tranches. This review has enabled NAMA to determine and advise the Central Bank of the expected discount of 67% on the remaining €19bn. of the bank's loans that are due to be transferred.

example, during this time the two larger banks, while not involved in any planning exercise, were nonetheless approached by the Governor of the Central Bank, who suggested to them that in the event of a potential failure of any of the smaller institutions, they might need to be part of the solution to such an event. I understood from the Governor that indeed the two larger banks understood that such an event could threaten the system that sustained them and that they had indicated – hypothetically of course, since there was no case in point – that they would engage and try to play their part.[2]

Other intervention approaches were also considered and worked upon, while at the same time there was a lot of effort in CB/FR, the DoF, the NTMA and the banks themselves, with a view to ensuring that ongoing liquidity pressures could be addressed – various key papers outlining the development of various crisis resolution options during 2007 and the first half of 2008 have already been provided to the Oireachtas and published – links at Appendix 1. It was understood that in some other countries banks were being encouraged to repatriate funds so as to provide liquidity in their own domestic markets and the CB/FR was naturally encouraging Irish institutions also to be willing to share their liquidity with each other. This much is well known and I will go no further on this point, for the legal reasons explained earlier.

In the first half of 2008, there was absolutely no serious consideration, which I can now recall, being given in CB/FR, DoF or NTMA to a broad guarantee in respect of a wide range of institutions for a wide range of liabilities, as a discrete policy option, although of course, as I have just noted, there was

[2] I should note at this point that in the first half of September 2008, when it was clear that INBS was in significant difficulty, I told the staff in the FR that Bank of Ireland ("BOI") and Allied Irish Banks ("AIB") would have to be called in to assist in a resolution for INBS. The CB/FR met with the two banks and got a strong refusal – the banks were concerned that INBS' very high property exposure would be difficult for them to digest. Goldman Sachs produced an assessment when asked by the FR– based of course on information from INBS and its executives – as well as from documentary review, of the scale of difficulties with the INBS loan book. The assessment was perhaps a bit more upbeat than we had feared at the time, and in retrospect and with all the benefit of hindsight was hopelessly optimistic. On Sunday 21 September 2008, I heard their assessment in a meeting with Basil Geoghegan from Goldman Sachs and various others: while it might be difficult to get 100% back on some of the loans they had issued, there was nothing to suggest any losses could not be absorbed by INBS' own capital. In other words, they seemed to be in some trouble, would need some help, but were probably solvent.

ongoing work on legislative options which included consideration of how to enable Government to give guarantees in appropriate cases. But at various points in time it seems that a broad Government guarantee did feature in discussions in other quarters. The Governor of the Central Bank, I believe, received approaches in March/April 2008 suggesting that the Government should announce a broad guarantee – though it is possible that what was in mind at this time was a general political undertaking rather than a formal guarantee. While those approaches probably reflected particular pressures around and just after St Patrick's Day 2008, I believe the concept persisted in some form for some time after, and was raised in certain discussions with the Department of Finance, and perhaps also with the Central Bank in Summer 2008, but I am not aware of any extensive discussion between the Department and other parties on this concept at this point in time

The Committee is well aware of the liquidity crisis that gripped the banking sector in September 2008, and I have described in detail the events of that month in Appendix 2. At that point, a range of interventions in the banking sector were being considered, including the nationalisation of INBS as a measure to stem the institution's liquidity drain. However, when Lehmans filed for bankruptcy on 15th September 2008, the liquidity situation became critical and there was widespread panic in the financial markets and among the general public.

The decision taken by the Government on 20th September 2008 to increase the level of protection for bank deposits from €30,000 to €100,000 worked well to assuage the concern among individual depositors and avoided a run on INBS.[3] However, that measure was almost worthless to bigger depositors whose sentiment towards Irish banks could change overnight. Nobody involved with the decision expected anything other than a short respite, a little time to continue working and planning.

[3] Most of INBS' deposits came from smaller depositors and thus the increase in the deposit guarantee eased the liquidity pressure on that institution.

Early in the September discussions on the problems of INBS and others, it became clear that there was not a sufficient understanding available from CB/FR of the internal workings of the banks which were apparently in difficulty, and also that there might be important demands for corporate finance and accounting expertise to flesh out the expertise already available among the official parties.

With the encouragement of DoF and NTMA, Goldman Sachs were commissioned to conduct initial work on the loan book of INBS, and also some very initial work on Anglo, PWC were engaged to carry out more detailed work on the various loan books of the banks in general, and Morgan Stanley were approached by DoF, in consultation with the NTMA, to become the external advisor to the Minister for Finance and NTMA – after a couple of days of engagement, these advised that they might have conflicts which would prevent them doing a thorough job, so Merrill Lynch were first consulted, then commissioned by the NTMA as advisors for the NTMA and Minister.

To formalise this arrangement the Minister made a formal direction to the NTMA to make advice available to him, including by the commissioning of external advisors. Separately, Arthur Cox were commissioned as legal advisors to supplement the services available from the Attorney General. Over the years that followed, the external advice arrangements changed, and there was an additional focus in both the DoF and NTMA on taking in external staff with specific expertise relevant to the crisis, while there was a wholesale restructuring and growth in staffing in the CB/FR.

As matters developed, the roles of NTMA in both advisory and executive matters changed. Through the NPRF, NTMA staff were heavily involved in the management of the State stake in the banks and from early 2010, there was a specific delegation of advisory functions from the Minister for Finance. Tendering procedures etc led to changes in external advisors also, Merrill Lynch being replaced by Rothschild's, for example, and of course the set-up of NAMA led to a strong growth in consultancies, while various stress tests and the like meant a big role for external advisers in the CB/FR.

Introduction

This Report is my summary of what happened, to the best of my knowledge and recollection, in certain key periods of Ireland's economic and financial crisis and is designed to give the Committee information to inform their deliberations. It is based on personal recollections, notes and records and is entirely from my own perspective. Events were so complex in these periods that this is necessarily a summary presentation and of course other persons involved would have their own perspective and other information.

On Friday 5th September 2008 I received a telephone call from William Beausang – a colleague who was heading up the secret work we had been doing on banking crisis preparation. He told me that he had heard from the Financial Regulator's office that an incorrect report had been circulated by Reuters about Irish Nationwide Building Society[1] and that as a result, the Regulator feared a run on the building society's deposit base the following week – they were asking about my availability first thing Monday morning.

Mr Beausang and I spoke about that – if there was to be the potential for a 'run' on Monday, then we better get to work straight away. And the planning for such an event envisaged an immediate meeting of the Department of Finance, the Central Bank, the Financial Regulator and the NTMA. I pressed for a meeting the following morning, and a large group of institutions as necessary). The plan, which was never finalised and implemented, because the situation kept changing - provided for the institution to be taken into state ‘protection’ – in other words, nationalised. If it became clear that the institution’s ongoing liquidity drain was not going to be staunched, meetings would be called over a weekend, a new chairman and some new directors would be selected, formal directions from the regulator would be drafted, so that the existing management would, in effect, be under instructions from the regulator to be cooperative for the few short days it was envisaged it would take to bring a Bill to the Oireachtas and have it passed. Lists were made of all the individuals and institutions who would have to be contacted to ensure that all of this could happen. Regulators in other jurisdictions would have to be informed, the ECB would have to be consulted, and arrangements for communications with depositors and shareholders would be put in place, to reassure them. The civil service head of IT and the Department of Finance press officer quietly made contingency arrangements to have a new call centre up and running on very short notice, and messages of the type that would be needed for press and public were drafted. In such an event, bank branch Managers would be contacted over the weekend to allow them to be informed of developments before opening on the Monday. At all costs, the terrible demonstration various technical groups, there were about 15 people in the room in a conference room in Merrion Street, and the atmosphere was tense. The Taoiseach and the Secretary General to the Government, the Attorney General, the Central Bank governor and his Director General, Tony Grimes, Pat Neary and Jim Farrell, CEO and Chair of the Financial Regulator, respectively, and of course the Minister for Finance, with my immediate boss, David Doyle and myself in attendance. Michael Somers and John Corrigan attended from the NTMA. From the various advisory groups, Merrill Lynch, Goldman Sachs (briefly), Arthur Cox and PWC were represented – the latter having at last been commissioned by the Financial Regulator to do more in-depth analysis on the funding and loan books of the banks[d4].

Various possibilities for intervention in the banking system were considered, including lending to the banks to help their funding position, providing them with government bonds which they could use to access Central Bank funding, giving them guarantees to allow them to access funds from the public and on the money markets, and the nationalisation of one or more banks was also very much on the agenda. I made clear that the situation was very urgent –stating the obvious. The discussion also made clear that there was a lot of uncertainty about the underlying future of the banks – the Financial

[d] The commission had to come from the independent Central Bank and financial regulator, as they had access rights to the banks that the Department of Finance and NTMA never enjoyed, but my NTMA colleagues and I had strongly encouraged the regulator to take this initiative. The results were shared among the authorities and the Dame Street people were pragmatic in ensuring that everyone who needed access to the data could get it. A few months before, this would have been anathema.

THEME: R1

Effectiveness of the regulatory, supervisory and governmental regime structure

LINE OF INQUIRY: R1c

Appropriateness of the macro economic and prudential policy

IFSC Clearing House Group

Thursday, 16 October, 2008, at 8.30am
Room 308, Department of the Taoiseach

Minutes

Attending:

Dermot McCarthy (Chair)	D/Taoiseach
George Shaw	D/Taoiseach
Patricia Waller (Secretary)	D/Taoiseach
Gavin Caldwell	Pensco
Michael Ryan	Merrill Lynch
Sean Gorman	D/Entreprise, Trade and Employment
Andrew Healy	National Irish Bank
Gary Tobin	D/Finance
Brian Finn	D/Finance
Marie Hurley	Revenue
Jim Byrne	Revenue
Tony Golden	CITI
David Fagan	Legal and General
Padraig Rushe	Bank of Ireland
Michael Deeny	DEPFA
Con Horan	Financial Regulator
Patrick Neary	Financial Regulator
Micheal Deasy	Financial Regulator
Kevin Sherry	Entreprise Ireland
Mick Sweeney	Bank of Ireland
Pat Farrell	IBF
Gary Palmer	IFIA
Pat Wall	PricewaterhouseCoopers
Brendan Kelly	FSI
Aileen O'Donoghue	ISE
Tim Hennessy	DIMA
Kieran Donoghue	IDA Ireland
Barry O'Leary	IDA Ireland
William Beausang	D/Finance
Breda Power	D/Enterprise, Trade and Employment

Apologies:
Willie Slattery

1. Apologies
Apologies were received from Mr. Slattery.

2. Minutes and matters arising
There were no matters arising.

3. Reports from the Working Groups

The Chair invited the Chairs of the working groups and the task forces to report back to the group on the impact of the current climate on their sector.

(i) Banking and Treasury Working Group (Padraig Rushe)

Mr. Rushe informed the Group that a strategic review had been carried out by the members of the working group in September. The main conclusion was that for all sectors tax matters were affecting competitiveness. Industry had put forward a short list of items that they believed would improve the situation. The public side were continuing to negotiate the tax treaties and to increase the overall Treaty network. There were issues with this approach including the time it would take.

Mr. Rushe stated that the public and industry members of the Clearing House Group needed to make decisions to resolve obstacles rather than just identifying them. There is a need to make clear which ideas should be acted upon. There were positive reactions domestically and internationally to the recent decision by Government on the provision of the bank guarantee scheme.

(ii) Insurance Working Group (David Fagan)

Mr. Fagan explained that the Group considered that the impact of the current climate on the insurance industry was not as extreme as it had been on the other sectors, notwithstanding the AIG situation. However, Mr. Fagan informed the group that there were concerns about possible future developments in the wholesale reinsurance market.

The IDA insurance pipeline activity is healthy across several sectors. There is a trend by multinational groups to bring assets home and less focus on foreign subsidiaries. In relation to Luxembourg, Ireland is now suffering growth and maturity problems. However the current climate could act as a catalyst for re-growth allowing us to re-energise the process. The bank guarantee scheme is seen as a decisive step by other jurisdictions.

Mr. Fagan re-iterated his belief that the Clearing House Group had great potential for public and private collaboration.

(iii) Funds Working Group (Gary Palmer)

Mr. Palmer informed the Group that the current climate has had a significant impact on all aspects of business but especially on money market funds. Germany and Luxembourg made an announcement this week about securing their funds. It would be important for Ireland to have an announcement guaranteeing the liquidity of its structures. He added that it would be very helpful if Government Departments could engage with the Central Bank in anticipation of the announcement. Impact statements would take the heat out of the market.

The competitiveness committee recommendations that were presented to the Group at the last city meeting pushed for collaboration, cooperation and coordination to bridge the competitive gap between Ireland and Luxembourg. Some recommendations were put forward at the last meeting of the funds group.

(iv) Pan European Pensions Task Force (Pat Farrell and Pat Wall)

Mr. Wall stated that we have done well in the pensions space, building asset pooling and added that the incentive to renew our approval is there but action needs to come straightaway. Currently there isn’t a serious market for pensions in Europe. We should focus on getting treaty status for our product, the CIF. This presents an opportunity for Ireland in the current climate.

(v) Asset Management Task Force (Gavin Caldwell)

Mr. Caldwell stated that although the Task Force has been operating for six years it hadn’t experienced much success. There is a need to examine the reasons for this. He suggested that there is a complete disconnect between what’s discussed at the CHG and what happens in the groups. He pointed out that the skills issue had come onto the CHG agenda recently and informed the group that only 30 CFA’s were currently operating in Ireland. He was encouraged by the initiatives being taken by the IDA in relation to the marketing of the IFSC and Ireland Inc but warned that the marketing role needs to be coordinated.

4. General discussion

Mr. Farrell stated that the sector’s reputation had taken a battering internationally and domestically. Engagement between the public and private sectors is at a low level. There is a need to remind ourselves of the fundamentals. There are 100,000 people working in this area making a significant contribution to the Exchequer. There is a need for a vigorous outbound marketing campaign from industry and the public sector focusing on the promotion of ‘Ireland Inc.’ and why the IFSC is a good location for financial services internationally. There is an urgency to appoint a champion for the industry as well as a Task Force with particular individuals to ground out a specific list of actions.

Mr. Brendan Kelly suggested that there was a common theme to the reports. There is a need to move forward and create solutions. He stated that there was a need to hear the public sector response at the next meeting.

Mr. Michael Sweeney stated that in relation to the agenda of the CHG there was a need to separate tactical and operational from the strategic issues. There are a number of tactical issues which need to be dealt with urgently. There is a need to identify the critical issues and how to resolve them. He asked what type of industry we need in 5-10 years time, what are the critical issues. He pointed out that all of the relevant players are members of the CHG or its working groups.

Mr. Wall emphasised the need to act quickly and within the rules of the EU and the OECD. He pointed out that Ireland is not in the same position as Luxembourg and Switzerland in terms of their banking secrecy rules. He stated the in the future the world focus would be on transparency and proper regulation. Ireland is strategically in a strong position but there is a need to convert this into competitive advantage with a correctly positioned, collaborative marketing message.

Ms. Aileen O'Donoghue suggested that Ireland has a very good story to sell. There is a need to examine how best to market this message competitively and defensively to the world. It is important to use the IDA network to stop momentum building against Ireland.

Mr. Michael Deeny suggested that there was a need for State support of the industry. He spoke to the group about the ACS market stating that this is an excellent product which is under threat due to market perception. He pointed to other jurisdictions such as Germany and Luxembourg which had already come out in support of their covered bond markets. He asked that a statement of support be issued from the Government. He mentioned that the international perception surrounding the case of DEPFA Bank questioned why they weren't included in the Irish bank guarantee scheme. France, Belgium and Luxembourg have bailed out Dexia.

Mr. William Beausang informed the group that timing was of the essence. The issues raised are important domestically and internationally. There is a need to engage bi-laterally on these issues. He re-iterated the call to examine the activity of other jurisdictions to see where the opportunities lie. He stated that in times like these it was important for national governments and central banks to take the lead. It is not a case of business as usual; there is a need to act strategically for the future, building on what we are today.

Mr. Tony Golden noted that the IFSC had effectively been sidelined over the last two/three weeks. He stated that representing the banks is not easy; they haven't been able to communicate the impact of the scheme on the sector to D/Finance or other stakeholders. The current IFSC bank model needs to be remodelled. The consolidation of the IFSC at 12.5% tax is not going to be attractive to bank's loanbooks. There is currently a change management focus at senior management level in banks worldwide. Ireland needs to move fast to identify what will be the new centres of growth and in what product areas.

Mr. Michael Ryan stated that there is a need to take the opportunities presented but it is equally important to leave a good impression of ourselves with the international banks and the parent company's of those banks. Ireland has the advantage of being first out of the gate but others are also taking a broader view in terms of the support for the industry.

Mr. Gary Tobin stated that the Department of Finance and industry had achieved a lot in through dialogue over the years. The problem referred to by Pat Wall is unique. The fact that the IFSC has always been properly regulated will be important moving forward and with the increased focus on the international tax environment creates a problem for the banking and treasury sector. The reputational quality is very important.

There is a continuing inversion of international companies into Ireland. He stated that Ireland is currently getting a lot of negative attention and as such this is not the time to be making fiscally aggressive tax moves. There will be 15 new double taxation treaties in the next twelve months. The Turkish Minister will be signing a double taxation agreement next year. Any unilateral tax moves would jeopardise this.

The Chair stated that there is a need for this group to provide pointers towards the development of Ireland's strategy to optimise our prospects. He agreed that there should be a distinction between the operational/tactical and the strategic. He suggested that the strategic thinking needed to be done in a smaller group. Coherence of the marketing message into a positive statement is important. It should include an energetic statement of our strengths and potential.

Mr. Pat Neary stated that the rules of the game had changed but that Ireland has a robust investor attitude that now needs to be built upon. From a customer perspective there is a need to drive forward strategy but there also needs to be a proper regulatory balance.

Mr. Barry O'Leary stated that IDA Ireland had agreed on the working groups that they would do two major projects on the international stage. He also mentioned that the Minister for Finance had agreed to travel with the industry on two trips abroad.

Mr. Sean Gorman stated that the Department of Enterprise, Trade and Employment has an important role in terms of skills and the marketing message through the IDA. He informed the Group that funding had been ring fenced for a skills programme in the Department's vote and that they were working on the delivery of this programme. He stated that the Department would be happy to work with the groups on this initiative. He emphasised the importance of industry engaging with the public sector whom he described as the potential 'enablers'.

Mr. Kevin Sherry stated that the industry was made up of different sectors that needed an individual response. He outlined a number of initiatives on hand with Enterprise Ireland to the group. Enterprise Ireland are very open and interested in seeing how things can be moved forward.

Mr. David Fagan pointed out that Ireland has a very broad spread of financial business and a competitive advantage might not be possible.

The Chair suggested that it would be useful to meet with the Chairs of the working groups and task forces in advance of the next meeting of the group to discuss the strategic future of the Industry.

5. A.O.B.

None.

6. Date of the next meeting

The next meeting of the Clearing House Group will be held on 20 November 2008.

Note to Witness

This document, *Crisis Management: Selected Extracts from 5 Banking Reviews*, was prepared by the Banking Inquiry Secretariat as an aid to the Witness.

It is a compendium of selected extracts from the findings of the five reviews commissioned or undertaken by either Government or the Houses of the Oireachtas on the banking crisis.

The headings, sub-headings and other categorisations used throughout were prepared by the Inquiry Secretariat for indicative purposes only and do not necessarily correspond with those used in the five reviews.

The Witness is advised to give primary reliance to the original reviews referenced in this document when preparing testimony; the abbreviations used and associated titles are as follows:

Abbreviation	**Title of Banking Review**
'Honohan'	The Irish Banking Crisis – Regulatory and Financial Stability Policy 2003 – 2008 A Report to the Minister for Finance by the Governor of the Central Bank *31 May 2010*
'Nyberg'	Misjudging Risk: Causes of the Systemic Banking Crisis in Ireland Report of the Commission of Investigation into the Banking Sector in Ireland *March 2011*
'PAC'	Houses of the Oireachtas Committee of Public Accounts: Report on the crisis in the domestic banking sector: A preliminary analysis and a framework for a banking inquiry *July 2012*
'Regling and Watson'	A Preliminary Report on the Sources of Ireland's Banking Crisis *2010*
'Wright'	Strengthening the Capacity of the Department of Finance – Report of the Independent Review Panel *December 2010*

C1 - Pre-Crisis Situations

Pre-crisis – Context Statistics and Precipitative Role of D/Finance

GDP Growth

From 1988 to 2007, real GDP expanded by 6 per cent per annum on average (reaching double digit growth during 1995-2000). Unemployment plummeted from 16 per cent (on the ILO basis) in 1994 to 4 per cent in 2000 – essentially full employment for the first time in modern history *(Honohan, p. 21)*

Department of Finance's role

The Department paid insufficient attention to broader macro-economic risks. While suitably direct on the risks of excessive spending and tax relief, annual departmental advice to Cabinet generally did not consider the broader set of macroeconomic risks. It did not, for example, consider the risks related to the extraordinarily expansive monetary conditions, which substantially heightened the risks of pro-cyclical fiscal action identified by the Department. This too, represents a significant deficiency. *(Wright, p. 30)*

Instead of analysing and stressing the nature of macroeconomic risks, the Department relied on the views of bodies such as the Central Bank, which was tasked with guarding financial stability. The Department of Finance … was reluctant to oppose packages that included outcomes that retained labour peace for the economy as a whole. *(Wright, p. 25)*

Faced with politically-driven tax and spending priorities, the Department was not forceful in seeking changes in other areas that could compensate for inflationary, pro-cyclical, or tax base narrowing effects. *(PAC, p. 108)*

The Panel reviewed in detail the annual June Memoranda to Cabinet on Budget Strategy. Generally speaking, we found that advice prepared by the Department for Cabinet did provide clear warnings on the risks of pro-cyclical fiscal action. *(Wright, p.5)*

However, it should have adapted its advice in tone and urgency after a number of years of fiscal complacency. It should have been more sensitive to and provided specific advice on broader macroeconomic risks. And it should have shown more initiative in making these points and in its advice on the construction sector, and tax policy generally. *(Wright, p. 6)*

The June Memoranda clearly and consistently warned the Cabinet of the effects of pro-cyclical policies and high levels of spending. … [However,] no single analysis integrated all risks *(Wright, 3.23)*

While the DoF identified various risks to the economy and to its budgetary forecasts, no single comprehensive analysis integrating all of these risks (including risks emanating from the financial sector) and assessing their implications for the economy into the medium-term was carried out. *(Nyberg, p. 69)*

The Department was very clear on the risks to the Exchequer of a downturn in the construction sector, providing specific estimates of the fiscal risks, and clear advice on the dangers of relying on related tax revenues. However, there was no analysis or advice on the broader risk to the tax system from a more general downturn in economic activity from levels created in part by pro-cyclical fiscal policy. *(Wright, p.32)*

The DoF was generally conscious of the need to rein in both general government expenditure and tax reliefs that favoured the property market. For example, a 2004 brief prepared for the new Minister for Finance urged restraint in terms of growth in expenditure and tax reliefs and emphasised the need for base-broadening taxation measures. It also stated that competiveness should be maintained by controlling the domestic cost base and identified the need for capacity to respond to economic shocks. However, the brief was silent in relation to credit growth. *(Nyberg, p. 69)*

Despite repeated expressions of concern over the construction sector in Budget Memoranda to Cabinet and elsewhere, the Department did not organise a strategic response to the problem, or identify a full range of options to moderate activity in the sector. *(Wright, p. 31)*

When a 2007 ESRI commentary suggested that a housing bubble had formed, the Department's briefing note suggested that a soft landing was the likely outcome. *(Nyberg 4.5.8).*

Following concerns expressed by the Department of the Environment in 2005 on the effect of 100% mortgages on the indebtedness of households, the Department consulted the Financial Regulator *(Nyberg 4.5.9).* In its response to the Department of the Environment, the Department took the position that this was a consumer matter rather than a financial stability one, and that consumer caution and provision of appropriate information would prevent the matter causing extensive problems. Secretary-General Cardiff repeated this view in evidence to the Committee in 2010 *(PAC 6/5/2010 at p. 59 and PAC, p. 111).*

Despite mounting concerns about the fiscal and macroeconomic risks caused by over-reliance on construction and the tax incentives and credit that fuelled it, the Department did not present cautionary arguments forcefully enough to the Minister and Government. In the face of repeated Government rejection of the Department's advice for moderation and reduction of property-based incentives, the Department did not organise a strategic response or prepare alternative approaches for moderating construction activities. *(Wright, 3.8 and PAC, p. 109)*

The CBFSAI could have privately expressed concerns about mounting risks to financial stability to the Department of Finance. There is no evidence that it did (*Nyberg 4.4.9).* The Secretary-General of the Department was an *ex officio* member of the board of the FSAI. *(PAC, pp. 98-9)*

Department of Finance's Skillsets

The transfer of treasury operations to the NTMA helped create a very capable institution with a very broad remit. However the change weakened the skills set in the Department of Finance on finance and banking. This impaired the Department's capacity to respond to the banking crisis. *(Wright, p. 40.)*

When the banking crisis broke, the Department had neither the time nor the resources to conduct in-depth investigation of issues. This reflected shortages of skills in the requisite disciplines and inadequate knowledge of underlying developments in the sector. *(Wright, p. 33)*

It [DoF] lacked specialist staff and while it gave advice on the negative effects of the Government's tax policies over the years leading up to the crisis, it did not perform quantitative analysis on the broader risk to the tax system. *(PAC. p. 106)*

One possible consequence of the "silo think" was that the DoF, discouraged from interfering in the work of the independent FR and CB, remained seriously underweight in professional financial expertise and engagement. The Commission considers it likely that the lack of overall analysis and responsibility in so many Irish public institutions may have allowed a number of warning signs to remain undetected. *(Nyberg, p. 97)*

Pre-crisis – Precipitative Role of the Construction and Property Sector

High-Level Drivers

Macroeconomic and budgetary policies contributed significantly to the economic overheating, relying to a clearly unsustainable extent on the construction sector and other transient sources for Government revenue (and encouraging the property boom via various incentives geared at the construction sector) *(Honohan, p. 15)*

The property boom was funded by cheap credit, increasingly sourced abroad in the form of interbank borrowing as the growth in domestic deposits failed to keep up with the explosion in credit. In some years, more than 80 per cent of the annual increment in credit went to fund a combination of house purchase and construction activity. While there were occasional warnings, on the whole, both domestic and international commentators took a benign attitude towards the risks that were building up. *(Wright, pp. 15-16)*

A perceived "permanent" downward shift in real interest rates and an upward shift in asset prices – accompanied in many cases by strong growth in household incomes – made mortgages an instrument of choice for balance sheet expansion. *(Regling & Watson, p. 15)*

Another factor, with even deeper roots, was the strong and pervasive preference in Irish society for property as an asset, and the fact that Ireland had never experienced a property crash. *(Regling & Watson, p. 5)*

Whether taxation was a cause?

Why was the structure of taxation changed so massively?

First, and most importantly, the government repeatedly offered income tax cuts to achieve wage restraint in the context of the trilateral wage agreements. This seemed sensible at the time as revenue was booming. However, over time, this approach narrowed the tax base and made it more fragile because the "booming" part of tax revenue turned out to be a transitional phenomenon.

Second, the Irish taxation system favours systematically, and more than in other EU countries, property and particularly home ownership. Ireland is one of very few countries where interest payments on mortgages can be deducted from income tax yet there is no property tax….

Third, the Irish tax system includes a large number of "tax expenditures" (tax allowances, reliefs and exemptions from income tax which – to some extent – reflect the income tax cuts mentioned above). According to the OECD, by 2005 the cost of "tax expenditures" had become larger than the remaining income tax receipts…. (*Regling & Watson, p. 27)*

A self-reinforcing spiral developed: higher prices and values caused increased speculative buying of housing and land; evaluators based their estimates on these higher prices; this increased the demand and collateral for bank lending, which in turn raised prices as more funding was provided. This development ended as housing prices reached their peak at the end of 2006 and construction in early 2007. *(Nyberg, p. iii)*

Whether income was a cause?

In 2007 incomes peaked at 114 per cent of the EU average. Just two years later, Irish incomes were once again below the EU 15 average and in 2010 are estimated to be 8 per cent below the average with only Italy, Spain, Portugal and Greece recording lower levels of income. *(Wright, p. 16)*

Wage settlements accelerated markedly from the late 90s, in absolute and in relative terms. The "trilateral" wage agreements continued but became less relevant as workers negotiated supplementary wage increases against the background of full employment and an overheating economy. Compensation per employee, which had grown more or less in line with the euro area average until 1996, increased at two to three times the euro area average from 1997 to 2008. In nominal terms, annual gross wages in Ireland in 2007 were the highest in the euro area except Luxembourg. Ireland had also the highest price level in the euro area according to Eurostat statistics. Competitiveness deteriorated significantly. *(Regling & Watson, pp. 21-2)*

Economic overheating, along with the Social Partnership Process, led to a major deterioration in competitiveness in the Private Sector and to very high Public Service wages, especially relative to international partners. *(Wright, p. 25)*

Whether fiscal policy was a cause?

For a long time, Ireland's overall fiscal policy was considered to be exemplary because the country achieved fiscal surpluses every year from the mid-1990s to 2006, including the creation of a Pension Reserve Fund to make budget surpluses politically more acceptable. *(Regling & Watson,p. 24)*

Then budgetary policy veered more toward spending money while revenues came in. In addition, the pattern of tax cuts left revenues increasingly fragile, since they were dependent on taxes driven by the property sector and by high consumer spending. Ireland was also unusual in having tax deductibility for mortgages, and significant and distortive subsidies for commercial real estate development, yet no property tax. *(Regling & Watson, p. 5)*

Voted expenditure grew, on average, by about 11.5 per cent a year between 1998 and 2008…. Between 2007 and 2009, total general government receipts fell by 21 per cent. While the yield on all tax heads fell, the declines in capital taxes (stamp duty, capital gains tax and capital acquisitions tax) were especially sharp. *(Wright, p. 18)*

Government spending doubled in real terms between 1995 and 2007, rising at an annual average rate of 6 per cent. With the economy growing at an even faster rate, this implied a generally falling or stable expenditure ratio of expenditure to GNP until 2003. But thereafter the ratio rose, especially after output growth began to slow in 2007.

And, in a final twist, real expenditure rose by over 11 per cent in both 2007 and 2008, an unfortunate late burst of spending which boosted the underlying deficit at almost the worst possible time *(Honohan, p. 30)*

The ceiling on the income tax deductibility of mortgage interest for owner-occupiers was increased in 2000, 2003, 2007 and 2008. By 2006 Ireland was one of only four OECD countries which allowed income tax deductibility while not taxing imputed rental income or capital gains for owner-occupiers. Furthermore, no residential property tax existed *(Honohan, p. 31)*

The main reason for the sharp increase in the fiscal deficit in 2008-09 was the collapse in tax revenue. This was possible because the structure of tax revenue had changed dramatically from the 1990s to 2006-07. The composition of tax revenue had shifted gradually from stable sources of taxation, like personal income tax and VAT/excise taxes, to cyclical taxes, such as corporation tax, stamp duty and capital gains tax. The share of these cyclical taxes reached 30 percent of tax revenue in 2006; in the late 1980s it had amounted to only 8 per cent. The overall revenue-to-GDP ratio was more or less unchanged at around 35-37 percent from the 90s until 2007. *(Regling & Watson,p. 26)*

The main cause of the borrowing surge was the collapse in tax revenues in 2008-09 which appears to have been the most pronounced of virtually any country during the current downturn. …. Much of the reason for the revenue collapse lies in the systematic shift over the previous two decades away from stable and reliable sources such as personal income tax, VAT and excises towards cyclically sensitive taxes. Revenue became increasingly dependent on corporation tax, stamp duties and capital gains tax (in that order); the contribution of these taxes to total tax revenues rose steadily from about 8 per cent in 1987 to 30 per cent in 2006 before falling to 27 per cent in 2007 and just 20 per cent in 2008…. Had the tax structure been less cyclically sensitive, the fall in revenue in 2008 would have been much lower *(Honohan, pp. 28-9, Chart 2.8).*

[Another] factor[s] important to the crisis in Ireland was 'the degree to which adequate buffers were [not] built into national fiscal policies, after allowing for the transient nature of revenues from the financial boom'. *(Regling & Watson, p. 11)*

After some transitional arrangements, most of these incentives were abolished by 31 July 2008, after the expiration date of the schemes had earlier been extended on several occasions during 2000-08. *(Honohan, p. 31)*

Domestic policies did not act as a sufficient counterweight to the forces driving this unsustainable property bubble. Bank regulation and financial stability policy clearly failed to achieve their goals. Neither did fiscal policy constrain the boom. Indeed, the increased reliance on taxes that could only generate sufficient revenue in a boom, made public finances highly vulnerable to a downturn. *(Honohan, p. 20)*

Whether EMU was a cause?

Certain aspects of EMU membership certainly reinforced vulnerabilities in the economy. Short-term interest rates fell by two thirds from the early- and mid-90s to the period 2002-07. Long-term interest rates halved. Real interest rates were negative from 1999 to 2005 after having been strongly positive earlier. This contributed to the credit boom, the strong increase in household debt, the property bubble and the general overheating of the economy. The removal of exchange rate risk facilitated foreign funding, including for the growing current account deficits. This financing ease meant that Ireland's boom could continue for longer than without EMU membership, and the asset bubble could become bigger. However, it was clear in the second half of the 1990s that entering EMU would imply a permanent shift to a lower interest rate level which – naturally – was seen as advantageous. *(Regling & Watson , p. 24)*

During the years preceding the crisis, an important influence on banking developments was the continued increase in Ireland's integration with other European financial markets. Two changes in this area affected bank behaviour in Ireland particularly strongly:

- First, and more importantly, following euro adoption, there was a quantum change in the availability of cross-border bank funding without foreign exchange exposure. This clearly facilitated the lending boom in Ireland, while also meaning (on the very positive side) that large foreign exchange risks did not build up among end-borrowers of funds.
- Second, there was also an impact of foreign (especially UK-based) banks on competition for lending to the real estate sector.

Fiscal policies were pro-cyclical in most advanced economies in the years up to 2007, thus contributing to the build-up of internal imbalances in these economies and making them more vulnerable to a crisis. *(Regling & Watson, p. 13)*

Whether consensus was a cause?

For most of the past twenty years, the Irish economy was regarded as a model. Very few questioned this general consensus and those that did were ignored. The move from one of the poorest countries in the EU to one of the richest, in terms of annual income, fuelled expectations for increased spending towards levels in the rest of Europe. *(Wright, p. 19)*

Economic overheating, along with the Social Partnership Process, led to a major deterioration in competitiveness in the Private Sector and to very high Public Service wages, especially relative to international partners. *(Wright, p. 25)*

Warnings of a bubble

The Irish authorities had the data required to arouse suspicion about trends in the property and financial markets. The relaxed attitude of the authorities was therefore the result of either a failure to understand the data or not being able to evaluate and analyse the implications correctly. Both macroeconomic and banking data could, particularly when combined, have provided the authorities with an understanding of what was going on. The Financial Stability Reports (FSR) provided information on individual perceived risks but, in the Commission's view, the data should have raised greater suspicions by end-2005 or, at the latest, by 2006. *(Nyberg, p. 91)*

By the end of 2005, on a reasonable assessment, the authorities should have been sufficiently concerned about the emergence of a property bubble to consider aggressive action to deflate it: new house prices had increased by 40% since 2002; property-related lending in relation to GDP was double that of the UK and proportionate to population, house completions were six times higher in Ireland than in the UK.. 12% of the Irish working population was employed in construction and construction output accounted for 20% of Ireland's GDP. *(Nyberg, p. 60)*

Residential investment as a percentage of national output reached nearly 13 per cent in 2006, double its long-term average**.** *(Regling & Watson, p. 22)*

Real residential property prices jumped to almost four times their historic norm… The three-fold increase in average real property prices 1994 to 2006 was the highest in any advanced economy in recent times and, long before it peaked, looked unsustainable to most commentators *(Honohan, 2009 & p. 24)*.

In absolute terms, over the period 2002 to 2008, domestic property-related lending increased by almost €200bn which represents 80% of all growth in credit. This raised the share of property-related lending from under 45% of total credit in December 2002 to over 60% in December 2008. *(Nyberg, p. 14)*

Total loans to customers grew by an average of 21.8% annually during the period. Property-related lending grew even faster and the fastest growth of all was in speculative C&P lending which grew by an average of 56.5% each year. *(Nyberg, p. 16)*

The covered banks' exposure to C&P lending had grown to over 48% of GDP by 2008, up from 11% in 2002. *(Nyberg, p. 17)*

At end-2003, net indebtedness of Irish banks to the rest of the world was just 10 per cent of GDP; by early 2008 borrowing, mainly for property, had jumped to over 60 per cent of GDP. Moreover, the share of bank assets in property-related lending grew from less than 40 per cent before 2002 to over 60 per cent by 2006. *(Honohan, p. 26)*

The covered banks accounted for over 65% of the overall growth in property-related lending in Ireland over the period 2002 to 2007. Their domestic property lending to Irish residents grew by 262% to €168bn by December 2007. *(Nyberg, p. 15)*

The 2007 FSR included an analysis of commercial property and noted a growth in price-earnings ratios that implied overvaluation. *(PAC, p. 94)*

The current difficulties of the Irish banks – whether in terms of liquidity or solvency – are directly attributable to their over-lending for land and property investment, much of it through heavy short-term wholesale foreign borrowing. *(Honohan, p. 22)*

Formulation and reaction to crisis simulation exercises

Risk simulation

While the DoF identified various risks to the economy and to its budgetary forecasts, no single comprehensive analysis integrating all of these risks (including risks emanating from the financial sector) and assessing their implications for the economy into the medium-term was carried out. *(Nyberg, p. 69)*

A paper entitled *Crisis Resolution Options* was discussed by the DSG in mid-2008. It reviewed the possible procedures and potential pitfalls involved in dealing with a troubled bank or building society. Two main crisis options were considered, namely assisted private sector acquisition and nationalisation (other possibilities briefly considered in an earlier draft included use of ELA, alternative mechanisms for providing liquidity, for example by investing (against collateral) some of the liquid assets of the NTMA, and a blanket guarantee). However, the paper offered little detail about implementation of the various options including that of the issuance of a guarantee (for example, it did not address the question of possible inclusion of subordinated debt. *(Honohan, p. 117)*

The DoF prepared a scoping paper on financial stability issues in early 2008. It examined three cases: (i) an institution that is illiquid but solvent; (ii) an institution that is insolvent or is approaching insolvency; and (iii) a scenario in which it is unclear whether the institution is illiquid or insolvent. A number of possible solutions were identified for each of these scenarios. The paper discussed the circumstances under which ELA could be available to an insolvent institution (i.e. only after a State Guarantee had been provided), as well as nationalisation; it concluded that both a guarantee and nationalisation would require new legislation. An internal departmental presentation in February 2008 indicated that "as a matter of public policy, to protect the interests of taxpayers any requirement to provide an opened/ legally binding State guarantee which would expose the Exchequer to the risk of very significant costs [is] not regarded as part of the toolkit for successful crisis management and resolution". However, in a later presentation in April 2008, while this view was repeated, it was also noted that "there are circumstances where such guarantees may be unavoidable to maintain confidence in the overall financial system. *(Nyberg, pp. 75-6)*

AIB, BoI and Anglo all paid dividends during 2008, and a DSG minute dated 8 July 2008 notes a report by the Financial Regulator that a "line-by-line" examination by a "major bank" of its loan book showed profitability even using a "worst-case" scenario. (*PAC, p. 129)*

The underlying models were not reliable when basic market parameters changed context; and in addition, scenario construction, which is at the heart of successful risk analysis, was insufficiently imaginative in exploring macro-financial vulnerabilities and linkages. *(Regling & Watson, p. 20)*

If the CB had had greater concerns there was nothing preventing them from confidentially voicing these concerns to the Government while keeping its public messages benign. However, the Commission has found no evidence that this was done. The Commission notes that the CB did not choose to confidentially study worst-case contingency scenarios. *(Nyberg, p. 68)*

Role, responsibilities and objectives of the DSG
Context for the DGS's work The PAC summarised the causes, as enunciated in the various reports, as follows: • bank assets were concentrated in property, particularly commercial property; • lending and credit policies were relaxed and frequently ignored in the interests of growth; • risks relating to high loan-to-deposit ratios and the use of wholesale funding were poorly understood; • risk management was ineffective; and • contrarian views were inhibited by competitive pressures and consensus views. *(PAC, p. 32)* Regling & Watson identified four demonstrable warnings of the impending crisis as follows: 1. First, **lending trends** in the Irish banking sector – especially from 2003 onwards – feature a pace of expansion, and a rise in asset and funding risks, that should have rung alarm bells. *(Regling & Watson, p. 29)* 2. The second, and analytically even clearer, hallmark of mounting risks lay in the **asset concentration of some major lending institutions.** This was a threefold concentration. It featured loans to the property sector in general; loans to commercial property specifically; and within this latter group, development loans to interests associated with a limited number of key developers of commercial property. In this respect, Ireland stands out. *(Regling & Watson, p. 31)* 3. The **concentration of risks** in lending was a feature that made the banking system particularly vulnerable. Cycles in credit to commercial real estate are prone to particularly wide swings; and in the upswing of the cycle in Ireland, there is wide agreement that property development was well ahead of trends that fundamentals could justify. This put bank capital heavily at risk in some cases. ... Funding exposure is perhaps best illustrated by loan to deposit ratios (Charts 11 and 12). A ratio of above 200% for the system as a whole was higher than other comparable euro area economies, leaving a large hole to be filled with debt securities and interbank borrowing. *(Regling & Watson, pp. 32-3)* 4. The period from 2003 to 2006 saw **wholesale borrowing** by Ireland in the euro area markets grow rapidly as a source of funding, reaching, in Ireland, about 39% of the combined loan books for the six financial institutions at end-2006. The growth in short term borrowing was even more rapid, with securities of one year remaining maturity or less amounting to €41bn at end 2006 for the two largest banks, up from €11.1bn at end 2003. Rolling over such borrowings was predicated on the continuation of benign wholesale markets. *(Regling & Watson, p. 33)*
Work of the DSG The DSG exchanged information about financial markets and regulatory issues, developed procedures and legislation for managing financial stability crises, and participated in crisis simulation exercises. A note of a DSG meeting on 21 September 2007 includes an observation about the reliance of European banks on wholesale funding, adding "need to do more research on that". *(PAC, p. 127)*

The DoF saw itself as preparing legislation to be implemented by the other authorities, but appears to have avoided addressing other financial market issues unless brought to the table by the FR or the CB (for instance, Credit Union issues during the Period). This apparently was due to their legally independent status. The Commission could find no evidence that the DoF formally tried to influence the FR in its work. The DoF also did not make any efforts to strengthen its own financial market expertise despite crisis management exercises in the EU having shown a need for it among finance ministries. *(Nyberg, p. 93)*

Had the DoF taken a greater interest in financial market issues early on, preparations for dealing with the financial crisis would have been more comprehensive. It is well documented that the DoF consistently, though not forcefully enough, supported a less expansive fiscal policy, particularly regarding property market incentives. It also appears that worries about the developing financial situation were expressed internally from time to time by some DoF staff. However, nothing came of this as the CB and FR were seen as responsible for financial stability. *(Nyberg, p. 93)*

Being conscious and supportive of the independence of both the CB and the FR, the DoF provided very little comment or input to this process, nor did it assess how they fulfilled their duties until very late in the Period. Neither the CB nor the DoF seem to have considered the implications of a possible interruption in the flow of foreign funding. If such a scenario had been considered, the link between such funding, property market developments and bank solvency could perhaps have been uncovered. *(Nyberg, p. viii)*

Black Book

The Government had earlier concluded that it could not permit any Irish bank to fail (which the Commission understands was also the advice from the ECB), given the potentially very serious adverse effects on confidence in the banking system in Ireland and elsewhere. *(Nyberg, p. 78)*

The authorities began to explore contingency arrangements from mid-2007 onwards (in the wake of the Northern Rock crisis in the UK… Important initiatives taken during this period included the establishment, in line with EU guidance, of the Domestic Standing Group (DSG), which involved, for the first time, a specific structure for ongoing cooperation between the DoF, the CB and the FR. The National Treasury Management Agency (NTMA) also attended several DSG meetings. In addition, especially from mid-2008 onwards, many other meetings and informal interactions occurred between these institutions. A liquidity monitoring group was set up within the CB which led to a more systematic evaluation of potential problems the banks might face. In parallel, arrangements were made to ensure that banks had available the maximum eligible collateral to access refinancing by the ECB and that the mechanisms to allow possible emergency lending assistance (ELA) from the CB were in place. Finally, some "crisis management" exercises were held (one involving an EU-wide exercise) using the "Black Book" crisis management guide as background. However, in the actual crisis no use was made of the Black Book procedures. In early 2008, CB staff concerned with financial stability matters produced a draft document which outlined, in fairly general terms, the options available if an individual institution were to encounter difficulties (the possibility of a systemic crisis was not considered).

The investigations to date found that the 'black book' was, in practice, found to be cumbersome and was not relied upon. Experts consulted by the Committee suggest that this is in line with international experience that the more elaborate a plan, the more likely it is to be ignored in an actual crisis. On the other hand, an effective integrated command system (ICS) has been proven to be particularly helpful where crises require a response from a network of organisations and where there is potential for confusion as to lines of command. Given that the crisis-management structure envisaged by the DSG was not implemented, the Committee is of the opinion that there are outstanding questions about who ultimately made the decision to issue the guarantee, on the advice of whom and on the bases of what information. *(PAC, p. 151)* The CB did not choose to confidentially study worst-case contingency scenarios. *(Nyberg, p. 68)*
Adequacy of the DSG process, including consideration of the bank resolution legislation
General actions Among the actions taken to enhance preparedness were: (i) enhanced cooperation between the CBFSAI and the Department of Finance, via the Domestic Standing Group (DSG) including a crisis simulation exercise; (ii) the preparation of a crisis management manual, including specific institutional issues that arose in light of the Northern Rock collapse and preparation for the possible use of emergency liquidity assistance (ELA); (iii) enhanced monitoring of liquidity flows; and (iv) advance consideration of some practical issues relating to crisis resolution options. These are reviewed in turn. *(Honohan, p. 114)* The DSG reviewed options for resolving potential financial crises in June 2008. The main options considered were the assisted acquisition of a distressed bank by a private (i.e. non-State) buyer and nationalisation. Other options included ELA, investment by the NTMA, and blanket guarantees. The review did not detail how these were to be implemented and recommended that legislation for nationalisation and bank resolution be investigated. If a bank were to be nationalised, it was considered likely that a State guarantee would also be required *(Honohan 8.14).* Mr Kevin Cardiff, who in 2008 was Assistant Secretary-General with responsibility for banking, told the Committee in 2010 that the group's general view on these issues was informed by the Economic and Financial Affairs Council (ECOFIN), which had stated that no systemic bank should be allowed to fail *(PAC 6 May 2010 at p. 57, and PAC, p. 128).* Both Nyberg and Honohan note that much time was taken up by matters related to Anglo's share price and the effect of the Quinn/Anglo contracts for difference (CFD) situation. This prevented sufficient attention being paid to the mounting pressures on the banks, and actions - such as raising or conserving capital - that might have mitigated the risks they faced *(Nyberg 4.6.9, Honohan 8.15).* As the discussions regarding procedures for crisis containment started to unfold, early on a clear consensus view emerged that **no Irish bank should be allowed to fail,** in the sense of having to close its doors and not repaying depositors and other lenders. This strong view departed from the textbook view that only systemically important

institutions should be candidates for such protective treatment. *(Honohan, p. 119)*

Legislation

One specific issue highlighted during this period concerned the possibility of introducing a special resolution regime for banks. Existing company law provisions were unsuitable for dealing with financial institutions in difficulties. Following preparation of a background paper in June, the possibility of implementing such legislation was discussed within the Domestic Standing Group. It was concluded that the legislation would be complex and would take considerable time to prepare. *(Nyberg, p. 76)*

One important initiative was, however, pursued vigorously in the pre-crisis period, namely, the preparation (on a highly confidential basis) of draft contingency legislation that would (i) enable nationalisation of a financial institution;134 and (ii) provide for the issuance of a guarantee by the Government. *(PAC, p. 129)*

A General Scheme was prepared for draft legislation (known as the "Heads of a Bill") providing for nationalisation of a bank or building society and issuance of a guarantee by the Minister. The Heads refer only to a general guarantee of the borrowings and liabilities of the affected institution and do not distinguish between different classes of debts such as senior or subordinated bondholders. They do however refer to the possibility of a guarantee under another proposed Bill. *(PAC, p. 129)*

Role, responsibilities and objectives of the DSG

Pre-Liquidity Group - Macro Stress Tests

Despite the overall resource constraints present, it would have clearly been desirable for more intensive efforts to have been devoted earlier to analysing the possible evolution of commercial property prices. This is especially the case since evidence from elsewhere suggests that the bursting of a property bubble in this sector can have a considerably more severe adverse financial impact than in the case of the residential market. Also, in this context, priority would probably need to have been given to obtaining - via the Financial Regulator - more comprehensive information from the financial institutions regarding property related lending, including cross exposures as well as exposures associated with speculative equity investments; problems in this area appear to have continued unresolved throughout the period reviewed. *(Honohan, p. 85)*

Statistical tools to capture the full impact of asset bubbles on tax revenue are not well developed, otherwise it would have become clearer much earlier that the structural, underlying fiscal balance was much less favourable than assumed at the time. *(Regling & Watson, p. 25)*

Macro – that is, system-wide – stress-tests in financial stability reports allegedly showed most banks to have sufficient buffers against extreme shocks; but typically these tests did not combine funding and asset market shocks. With the benefit of hindsight, moreover, it is clear that these, like the micro stress-tests of individual institutions, were much too mild. *(Regling & Watson, p. 19)*

The underlying models were not reliable when basic market parameters changed context; and in addition, scenario construction, which is at the heart of successful risk analysis, was insufficiently imaginative in exploring macro-financial vulnerabilities and linkages. *(Regling & Watson, p. 20)*

A faster appreciation of the reality - and the associated looming costs - underlying the above elements would have allowed the authorities to take earlier, more decisive and more credible action. From this point of view it could have been useful to use specialists in restructuring to assess the financial position of the covered banks. The solvency position of Irish institutions could then have been strengthened with significant capital increases well before the renewed onset of the liquidity problems, and non-systemic insolvent institutions could in a "normal" way have had their doors closed earlier and been wound down over time. *(Nyberg, pp 85-6)*

Lending context

In a growth environment, readily available liquidity and perceived/expected demand for property can artificially inflate its value and create additional equity above existing loans. When the perceived demand and liquidity disappear, so does the supposed equity. Banks lent significant amounts to the Irish property market against apparent equity with the expected source of repayment being anticipated rental uplifts (in the case of property investment) or, in many cases, the refinance or sale of the asset. *(Nyberg, p. 36)*

Funding Gap

As the covered banks' domestic lending grew so substantially, retail and corporate deposits could not provide sufficient funding. … The covered banks' requirement for non-deposit funding increased almost fivefold over the period -2002 to 2008] from €26bn to €129bn and grew at a particularly high rate from 2004 to 2007. The rest of the banks had a similar though generally smaller funding gap. This funding gap was financed by wholesale market funding and largely represented increasing foreign borrowing by the banks. This foreign debt was used largely to fund the domestic property market. *(Nyberg. p. 20)*

Liquidity Group

Macro-economic data signalling the emergence of the two key risks – growing dependence on foreign funding and the concentration of bank lending in the property sector – did not appear to have caused acute concern [in the CB]. At least at policy level, the CB seems not to have sufficiently appreciated the possibility that, while each bank was following a strategy that made sense, in the aggregate, when followed by all banks, this strategy could have serious consequences for overall financial stability. This was a classic macroeconomic fallacy *(Nyberg, p. 92)*

From late summer 2007, the CBFSAI had been in increasingly crisis mode as it sought to prepare for the consequences of a possible looming liquidity squeeze for some or all of the Irish controlled banks. … Almost all of the efforts … were focussed on the important task of improving the contingent access of the banks to liquidity. *(Honohan, p.13)*

A Liquidity Group chaired by the Deputy Director General of the CB was established in early 2008 to obtain and disseminate information on liquidity developments from the main credit institutions and to identify any potential problems at an early stage…. While this exercise proved to be a valuable tool in helping to establish a 'real time' picture of liquidity developments during the turmoil, a comprehensive, daily picture of the actual liquidity flows had not been put in place before early 2009. During 2008, the liquidity situation deteriorated, as reflected in the unprecedented recourse to financing from the European Central Bank which rose from a monthly average of around

€6 billion in September 2007 to €20 billion in September 2008 *(Honohan, pp.116-7)*

While considerable effort was thus devoted to preparing for a liquidity crisis, this period was also noteworthy for the unravelling of the Quinn-Anglo CFD affair, which was not ultimately resolved in a satisfactory manner. This appears to have represented a major preoccupation for the Authority at a crucial time. (*Honohan, p. 118)*

As late as September 29 itself (and indeed for quite some time afterwards), the position of the CB and the FR seems to have been that Irish banks all remained solvent in the sense that they had to date met all prudential ratios, and that there was therefore little immediate cause for concern. The possibility that they might experience catastrophic losses in asset values into the future does not appear to have been given serious consideration even from a contingency policy point of view. *(Nyberg, p. 78)*

The stress tests that were conducted followed international practice and the standard qualifications as to their interpretation were presented. However, it is clear that the shocks involved, while thought to be extreme at the time, did not in fact capture the scale of what could and did happen. This was true of both the adverse international and domestic macro scenarios and the assumed deterioration in the quality of banks' loan portfolios. *(Honohan, pp 94)*

The stress tests showed the banks to be resilient to economic shocks based on the assumptions used. However, the more severe shocks were discounted as the banks were confident that a soft landing was likely outcome and that their loan portfolios and funding sources were sufficiently diversified. *(Nyberg, p. 45)*

Apart from the fact that the scenario was insufficiently severe, the capacity of the banks to undertake the exercise differed greatly; indeed none of them had reliable models, tested and calibrated on Irish data, which could credibly predict loan losses under varying scenarios. *(Honohan, p. 11)*

The presentation of aggregate weighted average results, in particular those of the "top down" approach, masked differential impacts across individual institutions. *(Honohan, p. 88)*

The absence of substantial analytical work by the CB – even on an internal, confidential basis – to consider the implications of an alternative, much less favourable outcome, is striking. *(Nyberg, p. 87)*

Implicitly it seems to have been assumed that lenders had protected themselves against loan losses through sufficiently low loan-to-value ratios (sufficiently high co-financing), or assurance of other sources of income to service loans. However, only the CBFSAI could have had access to the information that could confirm the true situation, whether through regulatory inspections or the bottom-up stress test exercises. But the approach used by the Financial Regulator did not yield the information needed and the implementation of the stress tests did not seek to verify or assess such aspects as loan-to-value ratios for development property lending. In the event, the implicit assumption that either the banks, or the Financial Regulator has ensured sufficient buffers against whatever fall in property prices might occur proved to be misplaced. *(Honohan, pp 94-5)*

The fact that loans to overlapping subgroups of the same set of property developers accounted for such a high fraction of credit outstanding from most of the credit institutions implied a systemic risk not captured in risk assessments carried out for one bank at a time. *(Honohan, p. 110)*

Trust in a soft landing was consistent and, though not very well founded, continued up until and including the crisis management phase of the Period. *(Nyberg, p. vii)*

Lending Caps

There appears to have been little serious thought given to the idea of setting binding or even non-binding limitations on credit extended specifically to the property sectors which had been expanding at truly unprecedented rates. Sectoral limits had in earlier years prior to the adoption of the euro formed a significant part of the arsenal of instruments used by the Central Bank. *(Honohan, p. 105)*

Alternatively, a ceiling could have been placed on the rate of growth of credit extended by one or more institutions, especially those experiencing dangerously high growth. This would have been a major departure from the moral suasion approach to enforcement and would not sit comfortably with market-oriented policy in normal times. *(Honohan, p. 105)*

Aside from ELA, although a large amount of resources had been devoted to preparation of the crisis management manual, it was not employed to any significant extent during the actual crisis. This was due to the fact that the procedures outlined were excessively cumbersome, and sought to involve too many officials of the Central Bank and Financial Regulator at a time when rapid decision making was at a premium. *(Honohan, p. 116)*

Role of advisors such as Merrill Lynch in analysis crisis management options

PwC

Addressing the Committee of Public Accounts in 2010 Mr Cardiff indicated that his main source of information on the state of the banks was the Financial Regulator. He conceded that the fact that it had been found necessary to send in PwC to get an accurate picture suggested that the Financial Regulator did not have entirely accurate information. *(PAC, p. 133)*

Asked about the conclusions he drew from Anglo's up-beat presentation on 18 September and its state four days later, Mr Cardiff told the Committee of Public Accounts that, while solvency was always a consideration, the focus of concerns was on liquidity because PwC's report had indicated that Anglo's loan book, while not comprising assets that would give it quick access to liquidity, showed only 3% impairment. This reflected accounting standards which prevented the bank from making provisions for impairment before the corresponding debts actually fell due. (*PAC, pp 130-1)*

This letter [from PwC on the Guarantee] provided assurances to Government that although some losses were likely, the problem remained one of liquidity rather than solvency, while the need for the increased capital was ascribed to market expectations. The DoF, in briefing the Minister, did not diverge from this view but added that the perceived weaknesses of Irish banks could threaten their ability to fund themselves. *(Nyberg, p. 82)*

Notwithstanding the benign view generally taken by the Authorities of the PwC initial assessment it has been argued – correctly, in the Commission's view – that the nature, scale and concentration of the exposures now listed should have aroused more heightened and widespread concerns that institutions were likely to face solvency difficulties. *(Nyberg, p. 85)*

Merrill Lynch

Responding to public disquiet, on 20 September 2008 the Minister increased the limits under the Deposit Guarantee Scheme to the lesser of 100% of deposits or €100,000. This stabilised retail deposits in the banks, but wholesale deposits continued to be withdrawn. The NTMA retained Merrill Lynch to advise on how to manage the crisis. *(PAC, p. 130)*

On 26 September [2008] Merrill Lynch presented to the Minister on the options discussed the previous day. The options outlined included nationalisation and a "Secured Lending Scheme" (SLS), under which the Central Bank would issue high-grade securities to the banks in return for collateral from their loan books; this would give the banks greater access to liquidity but would place the risk of the banks' loans on the Central Bank's balance sheet. Concerns about those risks, the Central Bank's relatively low cash buffer, and EU restrictions on State aids militated against this proposal *(Honohan 8.22 and PAC, p. 131).*

Another option was to use ELA to provide short-term liquidity. This too raised questions of the risk assumed by the Central Bank and the effect on its limited cash buffers. Given ELA's "last resort" nature, its use would cause reputational damage to Irish banks generally that could bring them all down *(Honohan 8.23, PAC, pp. 131-2).*

Other options presented to the meeting included guarantees, nationalisation, and the "bad bank approach". In relation to guarantees Merrill Lynch advised that depositors and senior bondholders should be covered, <u>and possibly dated subordinated bondholders.</u> A guarantee is described in the presentation as the "best/most decisive/most impactful" measure from the market perspective, but Merrill Lynch advised that a blanket guarantee for all banks could be a mistake and would affect Ireland's credit rating and prolong the survival of weak institutions. Minutes taken at the meeting emphasise the importance of credibility. The question of including dated subordinated debt was discussed. Undated subordinated debt holders are not mentioned in the Department's note of the meeting. *(PAC, p. 132)*

The potential for a major pay-out from the guarantee was not considered large, though no attempt was made at quantification. There were arguments against a blanket guarantee, including one made by the Department of Finance's advisors Merrill Lynch who observed that the assumption of such a large contingent liability would have an adverse effect on the borrowing costs for the State. And there is a moral hazard involved in any such guarantee, though this argument does not appear to have been made. Still, given the perceived lack of a solvency problem at Anglo (or the other banks) on balance a guarantee seems to have been the best approach, not least because no other clear and effective medium-term solution appeared available. This is not to underestimate the huge cost to the bailout which has ended up in excess of 15 per cent of GDP. (*Honohan, pp. 132-3)*

On Monday 29 September there was a dramatic fall in Anglo's share price and continuing deposit withdrawals. That afternoon, the Chairmen and CEOs of AIB and BoI requested a meeting with the Taoiseach and Minister for

Finance to discuss the impending collapse of Anglo and how it might affect their banks. A series of meetings followed involving the Taoiseach, the Minister, Merrill Lynch, CBFSAI and the Department. According to Honohan, AIB and BoI sought a general guarantee (including subordinated debt) and the nationalisation of Anglo and possibly INBS so as to remove their negative reputations and reduce the other banks' borrowing difficulties *(Honohan 8.30 and PAC, p. 132).*

Mr Cardiff was unable to tell the Committee whether AIB and BoI had brought documents or financial statements, and he could not produce a minute of their meeting with the Taoiseach and Minister, even though officials were present. *(PAC. p. 132)*

No contemporaneous records are available of the decision to recommend the adoption by the Government of the guarantee, and the Government's decision is subject to Cabinet confidentiality. However, Mr Cardiff stressed Merrill Lynch's observation that "the guarantee was the quickest means of making the greatest impact, although certain risks were associated with it". *(PAC, p. 134)*

Against this background, work intensified on recapitalisation options with the extensive input of Merrill Lynch. On November 28, the Minister announced that, on the basis of a report that analysed the loan books of the major financial institutions, their capital levels would remain within regulatory requirements in the period through to 2011 even under certain stress scenarios. However, in certain circumstances it would be appropriate for the State "to consider supplementing private investment with State participation". Following a negative market reaction to the release of Anglo's end year results, on December 14 the Government announced a recapitalisation programme of up to €10bn. However, the positive impact of this decision was undermined by the emergence of the "loans to Directors" issue at Anglo which led to the resignations on December 18 and 19 of the Chairman and CEO of Anglo respectively. On December 21, announcements were made regarding the capital injection of €1.5bn into Anglo and €2bn each into both Bank of Ireland (BoI) and Allied Irish Bank (AIB). *(Nyberg, p. 84)*

Liquidity v Solvency

Wholesale borrowing

During the years preceding the crisis, an important influence on banking developments was the continued increase in Ireland's integration with other European financial markets. Two changes in this area affected bank behaviour in Ireland particularly strongly:

- First, and more importantly, following euro adoption, there was a quantum change in the availability of cross-border bank funding without foreign exchange exposure. This clearly facilitated the lending boom in Ireland, while also meaning (on the very positive side) that large foreign exchange risks did not build up among end-borrowers of funds.
- Second, there was also an impact of foreign (especially UK-based) banks on competition for lending to the real estate sector.

Fiscal policies were pro-cyclical in most advanced economies in the years up to 2007, thus contributing to the build-up of internal imbalances in these economies and making them more vulnerable to a crisis. *(Regling & Watson, p. 13)*

Funding Gap

As the covered banks' domestic lending grew so substantially, retail and corporate deposits could not provide sufficient funding. … The covered banks' requirement for non-deposit funding increased almost fivefold over the period -2002 to 2008] from €26bn to €129bn and grew at a particularly high rate from 2004 to 2007. The rest of the banks had a similar though generally smaller funding gap. This funding gap was financed by wholesale market funding and largely represented increasing foreign borrowing by the banks. This foreign debt was used largely to fund the domestic property market. *(Nyberg. p. 20)*

Aggregate capital growth

The aggregate capital resources (including shareholder funds and subordinated liabilities) of the covered banks grew from almost €18bn in 2000 to circa €47bn at the peak in 2007. Though the covered banks continued to meet their regulatory requirements in relation to capital ratios, the composition of this capital changed materially. The proportion of shareholder equity in the covered banks' capital decreased significantly, with the balance being made up by subordinated loan capital. *(Nyberg, p. 41)*

The relatively greater losses seen in Ireland [than in the EU and UK] may thus be seen as a consequence of somewhat greater abandon in accessing wholesale funding and in lending to domestic property than in other countries. Thus, there is a difference in degree rather than in concept. *(Nyberg, p. 88)*

Liquidity issues

From mid-2007 onwards, cooperation improved between the key institutions involved and some important preparatory crisis management work was undertaken. However, the view that the only relevant problem was a threat to the liquidity position of the banks remained unchallenged throughout. There appears to have been no fears and, at most, a modest discussion on possible underlying acute solvency problems. This is true of the banks themselves as well as of the authorities. *(Nyberg, p. 93)*

On 5 September 2008 Reuters alleged that INBS was in talks with lenders to avoid insolvency. Although retracted, pressure grew on banks as both share prices and access to funding declined. Prompted by these concerns, the Department commissioned Morgan Stanley to review ILP, Pricewaterhouse Cooper (PwC) to review Anglo and Goldman Sachs to review INBS. *(PAC, p. 129)*

On 22 September 2008 Anglo requested liquidity assistance of €7 billion from the Central Bank. The DSG reviewed available liquid reserves, which came to approximately €18 billion. On the same day reports from the consultants' reviews of ILP, Anglo and INBS were received. ILP and INBS were reported to be vulnerable to loss of liquidity within weeks, but could survive with assistance. Anglo was on the verge of running out of cash in days. *(PAC, pp. 130-1)*

Inspections

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

in this connection. Financial stability analysis must be more integrated into supervision. It needs to capture liquidity as well as solvency risks. *(PAC, p. 80)* They were not the focus of any systematic checks, either desktop or on inspection; and, unlike the FR's principles for the protection of consumers, they were never incorporated into a unitary Code. *(Honohan, p. 46)* The number and type of on-site inspections carried out by the Financial Regulator was determined by financial institutions' risk ratings. In his 2007 Special Report the CAG found that the number of credit institution inspections fell significantly below target in 2005. He recommended that this be addressed along with the risk rating system in the report subsequently carried out by Mazars. *(PAC, p. 76)* Inspectors noted very serious failures of governance such as rapid balance sheet growth, regular breaches of credit policies and rising LTV ratios, excessive reliance on personal guarantees, grossly inadequate appraisals of major loan applications, and failure to analyse loans in terms of their effect on the entire bank rather than on their own individual merits *(Honohan 5.22-23).* Inspection reports of the Financial Regulator on Anglo in 2004 and 2007 both identified serious prudential deficiencies (*Nyberg 4.35*). However, the severity of these was not judged to be high priority *(Honohan 5.29).*
Liquidity v Solvency Liquidity (as opposed to solvency) supervision had been off the core Basel agenda for decades; and few regulators, if any, performed stress tests that combined asset market with funding shocks. In the euro area, financial integration and interdependency were goals of policy, and the side-effects on vulnerability were not strongly emphasized. *(Regling & Watson, p. 18)* A faster appreciation of the reality - and the associated looming costs - underlying the above elements would have allowed the authorities to take earlier, more decisive and more credible action. From this point of view it could have been useful to use specialists in restructuring to assess the financial position of the covered banks. The solvency position of Irish institutions could then have been strengthened with significant capital increases well before the renewed onset of the liquidity problems, and non-systemic insolvent institutions could in a "normal" way have had their doors closed earlier and been wound down over time. *(Nyberg, pp 85-6)* Following the Government's issue of the guarantee on 30 September 2008, it intensified its scrutiny of the covered banks to establish the extent of its contingent liability. PwC examined banks' loan books to get a clearer picture of their liquidity, while Merrill Lynch investigated the adequacy of capital. The preliminary results announced in November 2008 indicated that liquidity, rather than solvency, was the main issue of concern, though stress tests indicated that additional capital may be required to satisfy market expectations. *(PAC, p. 137)* Notwithstanding the benign view generally taken by the Authorities of the PwC initial assessment it has been argued – correctly, in the Commission's view – that the nature, scale and concentration of the exposures now listed should have aroused more heightened and widespread concerns that institutions were likely to face solvency difficulties. *(Nyberg, p. 85)*

C3 - Crisis: Appropriateness and Effectiveness of DoF actions & policies

Appraisal of conditions prior to increasing the Deposit Guarantee Scheme

Outstanding questions

The Department of Finance papers that were provided to the Committee give an unclear and incomplete picture of how events unfolded. There are many questions about what transpired in the period leading up to and on 29 September 2008 (the night of the guarantee). Some of the issues identified by the Committee that require further examination include:

- What was the precise sequence of events in the period of weeks leading up to the guarantee?
- To what extent was there an adequate evaluation of alternatives to the bank guarantee carried out by Government?
- Was the guarantee the optimal policy choice given the alternatives available?
- To what extent was the scope of the guarantee the optimal policy decision given the other options available to the Government?
- What role, if any, was played by the Cabinet in the run up to the events of the night of 29 September 2008?
- To what extent do written records exist of the events leading up to the guarantee, and the guarantee itself?
- Who were the external advisors (formal and informal) during the crisis management period and what were their roles? *(PAC, p. 17)*

Information supporting liquidity and risks assessments

The discussions for alternative measures before and on September 29, 2008, were conducted on the basis of very deficient information. The authorities were apparently convinced that bank solvency issues were not pressing or significant, as were the banks themselves, and that it therefore would be possible to resolve the acute liquidity issue. Furthermore, the liquidity problems appear to have been seen as temporary only and related mainly to international developments. If more relevant information on and analysis of the underlying position of some of the banks had been available, discussions and policy recommendations may have been very different. *(Nyberg, p. 93)*

The potential for a major pay-out from the guarantee was not considered large, though no attempt was made at quantification. There were arguments against a blanket guarantee, including one made by the Department of Finance‘s advisors Merrill Lynch who observed that the assumption of such a large contingent liability would have an adverse effect on the borrowing costs for the State. And there is a moral hazard involved in any such guarantee, though this argument does not appear to have been made. Still, given the perceived lack of a solvency problem at Anglo (or the other banks) on balance a guarantee seems to have been the best approach, not least because no other clear and effective medium-term solution appeared available. This is not to underestimate the huge cost to the bailout which has ended up in excess of 15 per cent of GDP. (*Honohan, pp. 132-3)*

The Government's limited insight into the large risks it was assuming cannot be excused. Had there been a proper understanding of the banks' situations in the years before the crisis, remedial action might have been taken, though given the depth of the crisis and the extent of the banks' exposure to property, even that is not certain *(Nyberg 4.7.11 –12, and PAC, p. 135)*

All the possible policy alternatives were at this time fraught with risk and the time for decisions was very short. Increasingly, the main issue at hand was seen as ensuring market financing for the banks at the beginning of the next day; making sure that "Ireland was open for business" in the morning. There is no evidence that the CB or the FR had substantial concerns regarding an emerging solvency risk among the banks. .... Initially the Guarantee was a success. *(Nyberg, p. 80)*

The absence of sufficient information on the underlying quality of the banks' balance sheets is likely to have had a significant impact on the alternatives that were considered reasonable on September 29, 2008. *(Nyberg, p. ix)*

Appropriateness of the Bank Guarantee Decision

Scope of Guarantee

Responding to public disquiet, on 20 September 2008 the Minister increased the limits under the Deposit Guarantee Scheme to the lesser of 100% of deposits or €100,000. This stabilised retail deposits in the banks, but wholesale deposits continued to be withdrawn. The NTMA retained Merrill Lynch to advise on how to manage the crisis. *(PAC, p. 130)*

The guarantee extended to all the deposits, covered bonds, senior debt and dated subordinate debt of AIB, BoI, Anglo, ILP, INBS and EBS. The covered banks were to fund the guarantee by a payment based on the estimated stress on the State's creditworthiness. *(PAC, p. 134)*

After the decision to issue the guarantee, AIB and BoI were asked to provide Anglo with immediate short-term liquidity. The two banks agreed to provide a total of €5 billion for a matter of days, subject to Government guarantee. The Central Bank also agreed to allow Anglo a €3 billion liquidity facility, which, following the inflow of funds consequent to the guarantee, Anglo did not draw upon *(Honohan 8.31 –8.32, PAC, p. 134).*

No contemporaneous records are available of the decision to recommend the adoption by the Government of the guarantee, and the Government's decision is subject to Cabinet confidentiality. However, Mr Cardiff stressed Merrill Lynch's observation that "the guarantee was the quickest means of making the greatest impact, although certain risks were associated with it". *(PAC, p. 134)*

Guarantee – options assessment

It could have been useful to consider using other available financing for a few days, using the time to assess ways of limiting the Guarantee and to urgently scrutinise the state of some banks. *(Nyberg, p. ix)*

If accurate information on banks' exposures had been available at the time it seems quite likely to the Commission that a more limited guarantee combined with a State take-over of at least one bank might have been more seriously contemplated. *(Nyberg, p. ix)*

This letter [from PwC] provided assurances to Government that although some losses were likely, the problem remained one of liquidity rather than solvency, while the need for the increased capital was ascribed to market expectations. The DoF, in briefing the Minister, did not diverge from this view but added that the perceived weaknesses of Irish banks could threaten their ability to fund themselves. *(Nyberg, p. 82)*

Given the information provided, the Commission understands the Government's decision to provide a broad guarantee for the banks; if no major solvency problems were expected the Guarantee would not have to be called upon. However, given the size of the amounts involved as well as the domestic and global uncertainties, it could have been useful to access available temporary funding to gain time to examine more thoroughly the advantages and disadvantages of alternative approaches. These could have included limiting the scope and duration of the Guarantee. However, there were concerns that the market would not have acted positively to such a delay at the time. *(Nyberg, p. 93)*

Buying time, even until following week-end, would not have been an idle exercise. It would have allowed the authorities the opportunity to assess more extensively the advantages and disadvantages of the alternative approaches available…. In the best case scenario, there could have been sufficient time to allow for the emergence of an initial common EU approach to the crisis. *(Nyberg, p. 79)*

Guarantee – necessary or not?

As regards the substance of the guarantee itself, it is hard to argue with the view that an extensive guarantee needed to be put in place, since all participants (rightly) felt that they faced the likely collapse of the Irish banking system within days in the absence of decisive immediate action. (*Honohan, p. 14)*

Unlike in the case of the Irish guarantee of September 2008, the Northern Rock guarantee extended only to existing and renewed wholesale deposits; and uncollateralised wholesale borrowing. It did *not* include other debt instruments such as covered bonds, securitised loans and subordinated and other hybrid capital instruments. (See Annex 4 for a discussion of the different classes of liabilities of banks involved. *(Honohan, p. 129)*

On night of the guarantee, the attention of Ministers became concentrated on how to avoid the short term risk of insufficient market funding in the morning. *(Nyberg, p. 79)*

… in all likelihood the main banks would have run out of cash within days. They did not have unused collateral eligible for borrowing at the ECB's facilities in sufficient amounts to meet a run on the scale which would have ensued. Absent Government support or ELA they would have to close their doors also, unable to pay out on cheques presented and other payments instructions. *(Honohan, P. 131)*

In the event, in the following ten days, six other countries introduced blanket deposit guarantees – though none of them were as extensive as the Irish scheme. While this is conjectural more prior consultation on alternative options might have alleviated the pressures on Ireland without creating the tensions prompted by a sudden unilateral action. After all, an EU-wide response to the crisis did eventually emerge in the following week. It is possible that recourse to ELA might have bought some time for such eventualities. In the event, in the following ten days, six other countries introduced blanket deposit guarantees – though none of them were as extensive as the Irish scheme. While this is conjectural more prior consultation on alternative options might have alleviated the pressures on Ireland without creating the tensions prompted by a sudden unilateral action. After all, an EU-wide response to the crisis did eventually emerge in the following week. It is possible that recourse to ELA might have bought some time for such eventualities. *(Honohan, p. 134)*

The Guarantee proved initially to be effective as there was a major inflow of funds to the financial system as a whole. However, Anglo was unable to recover the vast amounts of deposits lost in the run up to the Guarantee. *(Nyberg, p. 82)*

Guarantee – Scope right or wrong?

Honohan describes the guarantee's scope as "exceptionally broad", including as it did interbank deposits, covered bonds and senior and subordinated debt. Inclusion of long-term and subordinated bonds was not necessary to protect liquidity as these were "locked in". *(PAC, p. 134)*

The extent of the cover provided (including to outstanding long-term bonds) can – even without the benefit of hindsight – be criticised inasmuch as it complicated and narrowed the eventual resolution options for the failing institutions and increased the State's potential share of the losses. *(Honohan, p. 14)*

No other country had introduced a **blanket, system-wide, guarantee**, though this has been a relatively frequent tool in previous systemic crises… The inclusion of existing long-term bonds and some subordinated debt (which, as part of the capital structure of a bank is intended to act as a buffer against losses) was not necessary in order to protect the immediate liquidity position. These investments were in effect locked-in. Their inclusion complicated eventual loss allocation and resolution options. Arguments voiced in favour of this decision, namely, that many holders of these instruments were also holders of Irish bonds and that a guarantee in respect of them would help banks raise new bonds are open to question: after all, extending a Government guarantee to non-Government bonds has the effect of stressing the sovereign to the disadvantage of existing holders of Government bonds; besides, new bonds could have been guaranteed separately…. Subordinated debt holders have suffered some losses, given the buy backs that have occurred at discounted prices. Nevertheless, the inclusion of existing debt in the coverage of the guarantee likely increased the potential share of the total losses borne by the State. This eventuality deserved fuller consideration in advance. *(Honohan, p. 128)*

The inclusion of subordinated debt in the guarantee is not easy to defend against criticism. The arguments that were made in favour of this coverage seem weak: And it lacked precedents in other countries (although subordinated debt holders of some other banks since rescued abroad have in effect been made whole by the rescue method employed). Inclusion of this debt limited the range of loss-sharing resolution options in subsequent months, and likely increased the potential share of the total losses borne by the State. *(Honohan, p. 135)*

Effectiveness of reviews of bank loan books and capital adequacy

Bank information

The lack of information on bank exposures among the Authorities over time had profound implications for the decision actually taken. *(Nyberg, p, 94)*

C4 – Policy Responses: Appropriateness and Effectiveness of Policy Responses

Decision to nationalise Anglo in 2009 and alternatives available/considered

Decision

Having particular regard to Anglo's interconnectedness with the Irish banking system, it must be regarded as having been of systemic importance to the Irish banking system and could not have been allowed to fail. A disorderly failure would have caused lenders to avoid all Irish banks and without Government support or ELA they would have had to close *(Honohan 8.41 –8.43, Box 8.4 p.131, and PAC, 135)*.

On 9 January 2009 the Chief Executive of the Financial Regulator announced his retirement following the Financial Regulator's internal investigation into the Anglo directors' loans issue. That issue, combined with as-yet unpublicised information concerning back-to-back loans with ILP and loans relating to the Quinn Group's shareholding in Anglo, prompted the Government to announce the nationalisation of Anglo on 15 January 2009. *(PAC, p. 138)*

Establishment and operation of NAMA

Establishment and operating model

As part of the Emergency Budget in April 2009, the Minister for Finance announced a "bad bank" programme of acquisition of impaired bank assets as a means of providing liquidity to banks and improving their ability to raise capital on the markets. This was to be affected through the National Assets Management Agency (NAMA) established under legislation passed later that year.

NAMA functions by buying impaired loans from banks at a discount that reflects the loans' "long-term economic value". NAMA pays for the loans by means of bonds that the receiving bank can either hold or use as a means of raising liquidity from the Central Bank or ECB. Mr Brendan McDonough, Chief Executive of NAMA, cited "huge systems failures" in the banks leading to unrealistic valuations of loans in 2009, and agreed that "false and misleading information" was given to NAMA about them. As a result, NAMA takes a very strict approach to loan valuation, resulting in discounts averaging 53%, in contrast to the average of 30% suggested by some banks in 2009.

NAMA seeks to recover the full nominal value of the loan from the borrower. Where the underlying project for which the loan was granted appears unlikely to generate value, NAMA may move to realise the security (by way of receivership or sale of the secured property or other assets) or by calling in personal guarantees. Where the project for which the loan was granted appears to offer a prospect of a return within 3–5 years, NAMA is prepared to work with the borrower to achieve as much value as possible.

Returns on loans are applied first to recoup the sum NAMA paid to the bank for them. Any net surplus will be remitted to the banks from which they were bought. *(PAC, pp 142-3)*

After the banks have sold their largest property-related exposures to the State's asset purchase vehicle, NAMA, at a price based on their estimated —long-term economic value‖, and after they have made provision for all of their other prospective loan-losses the State will have taken sizeable equity stakes in most of the banks, and issued some €40 billion or more in Government-guaranteed NAMA bonds (in exchange for which NAMA will hold loans of a similar value). *(Honohan, p. 19)*

Scale of business

[In net terms, the State will have] issued some €40 billion or more in Government-guaranteed NAMA bonds (in exchange for which NAMA will hold loans of a similar value).

By December 2010 NAMA had purchased 11,000 loans involving approximately 850 borrowers and having a total nominal value of €71 billion. The price paid in bonds for these was approximately €41 billion, giving an average discount of nearly 58%. [58% does not tot, should be 42%]

In 2010 Mr Peter Matthews criticised the NAMA strategy, arguing that experience in US bank crises indicated that direct investment in the banks while leaving the impaired loans in place generated up to 10-fold returns. *(end of PAC extract)*

NAMA has to date paid the banks €32 billion for property development loans valued at €74 billion. However, the CAG estimates that for the first five tranches of loans transferred, NAMA paid 23% over their current market value, subsidising the banks by approximately €5 billion. *(PAC, p. 13)*

An even more revealing illustration comes from the multi-bank inspection carried out late in 2007, by which stage concern was growing about the large lending to property developers. Given that the portfolio being examined was eventually purchased by NAMA at a large discount, it is clear from the elements mentioned in Box 5.2 (Appendix) that the system was not set up in such a way as to detect even serious portfolio weakness, let alone quantify it *(Honohan, p. 70)* – see Appendix on Inspection in 2007

Appendix 1 of Honohan on 5 x 5 Big Developer Inspections, 2007

Box 5.2 - The 5 x 5 Big Developer Exposures Inspection, 2007

In December 2007, evidently reflecting a belated heightening of concern about large commercial property lending exposures, the FR embarked on a special multi-institution inspection to look at the handling by five banks of five large exposures. Complacently, —all institutions confirmed to the inspectors that they have no concerns with the current or future repayment capacity of any of the borrowers included in the inspection to which they are exposed. This optimism subsequently proved in all cases to have been mistaken.

The inspection nevertheless identified two —High Priority findings‖, both related only to a single institution. In line with the usual house supervisory style, these related to process rather than specific exposure issues. Thus, the inspectors noted (p. 11): —it appears that there is no comprehensive review of Group exposures conducted on an annual basis. Rather reviews concentrate on an ongoing high-level review of exposures and do not appear to involve a review of documentation such as Audited Financial Statements, Cash Flow Statements etc.‖ And, ―The inspectors were advised that certain valuation updates are based on 'management estimates. However, such estimates (which may be performed by the [identified senior management officer]) do not appear to be recorded. It is clear that the inspectors have detected a deeply flawed process, which should have caused great alarm.

Turning to what the inspectors classed as ―Medium Priority findings‖(M), several show how much trust the banks were placing in the unverified assertions of their borrowers with regard to their personal wealth, and how inaccurate some of the information being used by the banks was. Thus, consider the following :

M1: ―The inspectors noted that institutions have been unable to obtain a Net Worth Statement from [Mr. X], as he is unwilling to disclose such details in writing. In addition, the statements provided by [Mr. Y and Mr. Z] have not been certified by a third party.

M2: ―The inspectors noted that some estimates provided to the inspectors as to the overall indebtedness of Group exposures appeared to differ significantly from data available to the inspectors, e.g., [Bank A] advised that they believed the [Z] connection indebtedness to [Bank B] to be circa [€P00m], whereas the data provided by [Bank B] advise that the debt is currently circa [€1 billion more]. While such differences may arise because assessments are based on information obtained at different times, nevertheless the inspectors would question the manner in which institutions appear to be assessing Group Indebtedness as evidenced by the following:

(a) [Bank A] reviews the overall indebtedness to all credit institutions of [Mr. X] through discussions with [Mr. X] and his senior management team. However, no record is maintained of such discussions and as a result the inspectors were unable to obtain evidence that indebtedness had been reviewed.

(b) [Bank A] does not review the overall indebtedness to all credit institutions of [Mr. X] and the [Z] Connection, as [Bank A] focuses only on its own exposures and related security in these cases.

(c) The overall indebtedness of [Mr. Y] to all credit institutions is reviewed by [Bank A] through a review of his Net Worth Statement. On the basis that this statement is not certified by a third party, the inspectors would question whether this document should be the only source for assessing overall indebtedness used by the bank.‖

M10: Inspectors expressed concern about the adequacy of Bank D's understanding of its exposure to Z and W based on minutes of its credit committee:

"Chair echoed the Committee Members views, stating that whilst he acknowledged that the team had an understanding of each of the individual projects we were engaged with, the group as a whole was a much more complex entity by its very nature. Consequently, chair said that the opaqueness in the Bank's understanding of the wider group and our limited executive contact with [Mr Z], was extremely disappointing and reiterated that there is a clear need to escalate the level of understanding‖. In addition, the minutes also noted that ―the bank lacked a real understanding of the wider group liquidity, and we were unable to explain the inherent structural risk".

The [Bank D] Credit Committee meeting on 26 September 2007 stated: "Chair noted that the bank was not in a position where it had a full understanding of [Exposure W]'s liquidity". "It was thus strongly emphasised that the bank needed information as to how [W] will generate cash and what its wider strategy is, as well as gaining further insight into its local strategy in relation to the build-up of assets around [identified UK location]". The minutes also noted that "the bank was now heavily exposed to this group and uncertain at this stage whether [an amount in excess of €500 million] was the right number to be basing our appetite". M16: "The inspectors were advised that the calculation by [Bank E] of [Mr. X]'s net worth included [an amount in excess of €100 million] which represents working capital facilities provided by the bank. It was not clear to the inspectors how such debt increases [Mr. X]'s net equity." Despite this catalogue of banking deficiencies, the full implications of the obvious lesson – that loan appraisal had been wholly inadequate and personal guarantees could not to be relied upon – does not appear to have been taken on board by the regulatory system. Certainly, the implication that the solvency of all of the banks could be at risk given the declining value of collateral that must have already have been clearly in prospect was not one that was understood by the Authority. An indication that the participants in the exercise seem to have remained fairly relaxed about the findings is given by the perfunctory – or at least brief – character of the post-inspection close-out meetings (20 to 30 minutes). At this rate, how much regard can the banks have had for the inspectors
Decision to recapitalise Anglo, AIB, BoI, EBS, PTSB and alternatives available/considered
Anglo After the decision to issue the guarantee, AIB and BoI were asked to provide Anglo with immediate short-term liquidity. The two banks agreed to provide a total of €5 billion for a matter of days, subject to Government guarantee. The Central Bank also agreed to allow Anglo a €3 billion liquidity facility, which, following the inflow of funds consequent to the guarantee, Anglo did not draw upon *(Honohan 8.31 –8.32, PAC, p. 134).* Against this background, work intensified on recapitalisation options with the extensive input of Merrill Lynch. On November 28, the Minister announced that, on the basis of a report that analysed the loan books of the major financial institutions, their capital levels would remain within regulatory requirements in the period through to 2011 even under certain stress scenarios. However, in certain circumstances it would be appropriate for the State "to consider supplementing private investment with State participation". Following a negative market reaction to the release of Anglo's end year results, on December 14 the Government announced a recapitalisation programme of up to €10bn.145 However, the positive impact of this decision was undermined by the emergence of the "loans to Directors" issue at Anglo which led to the resignations on December 18 and 19 of the Chairman and CEO of Anglo respectively. On December 21, announcements were made regarding the capital injection of €1.5bn into Anglo and €2bn each into both Bank of Ireland (BoI) and Allied Irish Bank (AIB). *(Nyberg, p. 84)*
Anglo & INBS The State will also have had to write-off in the order of €25 billion in unrecoverable capital injections into two institutions – Anglo Irish Bank and INBS – whose prospective loan losses greatly exceed their initial accounting

capital *(Honohan, p. 19)*
Bank recapitalisation The direct cost to the State –through the recapitalisation of the banks –is now estimated to be €64.1 billion. This has been funded in part through using the State's own resources in the National Pensions Reserve Fund (NPRF), from which €20.7 billion has been invested in Allied Irish Bank (AIB) and Bank of Ireland (BoI). However, the majority of funding has come from borrowing. The general government debt *directly* related to the bank bailout is €43.4 billion, a figure that includes the €31 billion in promissory notes used to fund the liabilities of Anglo Irish Bank (Anglo), the Irish Nationwide Building Society (INBS) and the Educational Building Society (EBS). *(PAC, pp 12-3)* To put this cost in context, the direct cost of €64.1 billion is equivalent to — • 41% of GDP in 2011; • Approximately seven times what the State spends annually on education; • Over four times what it spends annually on health; • Over three times what it spends annually on social protection; and • Almost twice the State's total tax revenue. *(PAC, p. 13)*
Scale of Guarantee The gross amount of liabilities guaranteed [at end-September 2008] came to €365 billion, or almost 2½ times GNP. *(Honohan, p. 19)* At the end of 2011, the contingent liability from guarantees stood at €173 billion (110.3% of GDP) and the latest figures available to the Committee suggest that the total liability under guarantees fell by approximately €6 billion in Quarter 1 2012. *(PAC, p. 14)*

Distribution of largest debtors

Distribution of largest debtors

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

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

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

F43/1/09 **3 March 2009**

Office of the Minister for Finance

SECRET

Memorandum for the Information of Government
Emerging Budgetary Position

1. The purpose of this Memorandum is to update the Government on the emerging budgetary position taking on board the provisional end-February data.

Summary Exchequer Position

2. The end-February Exchequer Statement will be published today (3 March 2009) at 4.30pm and as such Exchequer data referred to in this memorandum is provisional and secret until it is published.

3. Taking account of the frontloading of the 2010 NPRF Exchequer contribution, an Exchequer Borrowing Requirement of some €20 billion for 2009 is the current published estimate. An Exchequer deficit of €2,085 million at end-February was recorded compared to a deficit of €125 million for the same period in 2008. The increase in the deficit for the most part reflects the significant weakness in tax revenues.

Tax Revenue

4. The Addendum forecast that tax revenue in 2009 would be €37 billion, a decline of 9¼% on the amount received in 2008.

5. Tax Revenues in the month of February are down 31% on the same month last year. Cumulatively, in the two months to end-February taxes are down 24%. The publication of this data will provoke significant comment and will raise questions about the achievability of the five-year fiscal consolidation strategy.

6. Simply extrapolating a 24% decline for the rest the year would imply a €6 billion shortfall for the year as a whole. However, there are some timing factors causing the very poor start to the year and at this stage the Department of Finance does not anticipate that the year-on-year position will remain as weak as this for the rest of the year. There is no doubt that taxes to date are very poor and there are substantial risks to the downside. At this stage a shortfall in taxes of the order of €2½ billion is now possible for the year.

Voted Expenditure

7. Total voted expenditure to end-February 2009 is up 2% (Current +3%, Capital -7%) on the same period in 2008. In addition, expenditure pressures are emerging. Higher Live Register costs associated with the very weak labour market could add at least €700 million to current expenditure projections. There

are also pressures on health expenditure and these are tentatively estimated to be at least €300 million at this stage. This means that expenditure overruns could amount to at least €1 billion.

Expenditure Implications on Additional Policy Measures

8. The Cabinet Committee on Economic Renewal, supported by a Senior Officials Group from relevant Departments, has been examining possible short-term measures to stimulate economic activity and support those who lose their jobs.

9. The proposals being put forward involve amounts of several hundred million in new spending. The Minister for Finance must re-iterate, as firmly as he can, that in view of the extreme spending and revenue pressures outlined above, such measures can <u>only</u> be agreed to if, <u>and only if</u>, they are funded in their <u>entirety</u> by <u>real</u> savings (not potential ones) from within the proposer's own vote or from realistic savings in other areas of public spending. To engage in additional discretionary spending at this time would destroy the whole credibility of the Government's fiscal strategy.

<u>Overall</u>

10. At this stage it is likely that the overall Budgetary situation could be €3½ billion worse than projected - a potential €2½ billion shortfall on tax revenue and possible overruns in expenditure of around €1 billion. This would mean a General Government deficit of at least 11½% of GDP.

11. The publication of the end-February data will lead to significant negative comment and the Minister believes the markets will react adversely. <u>It is essential that the Government takes action to bring the public finances back to the already agreed very high deficit target of 9½% of GDP.</u>

12. What has been delivered up to now has failed to satisfy the international markets sufficiently about precisely how the problems with the public finances will be solved. Failure to convince the markets will mean that we will have to pay increasingly high prices to raise debt and, if their confidence is lost, our ability to raise debt may also come into doubt. We must restore confidence and this requires us to publish a multi-annual budgetary plan of action and this action must begin in 2009.

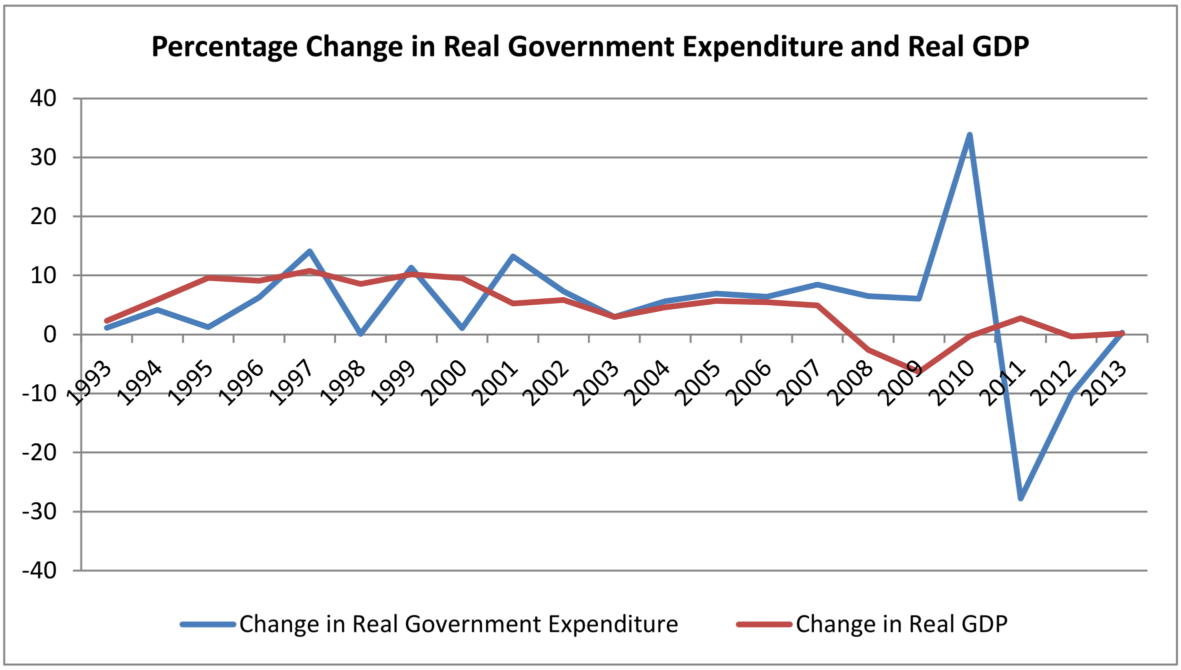
13. The Minister for Finance intends bringing to Government next Tuesday his plans in this regard. This will involve by end-March -

    (i) the introduction of additional taxation and expenditure measures in 2009 to address the continued deterioration in the public finances; and
    (ii) the publication of detailed taxation and expenditure plans for the coming years out to 2013 but with particular emphasis on the period to end 2011, which can then be reviewed on an annual basis in light of emerging developments.

14. The Minister recommends that the Government should issue a press release (copy attached) on the end-February Exchequer Returns indicating that it is considering the steps needed to address the deterioration in the public finances.

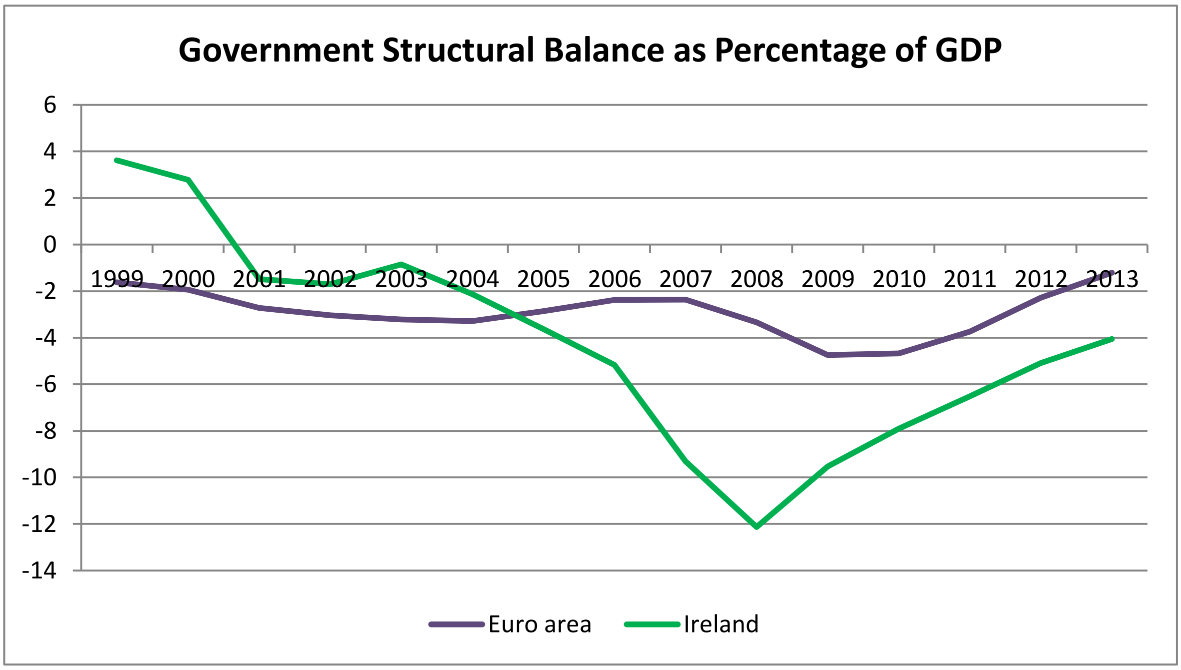
15. In addition, there is a private members motion on the Government's management of the public finances in the House tonight and tomorrow night. During this debate it is the Minister for Finance's intention to announce that the Government is currently considering the action necessary in 2009 to hold to the agreed deficit target.

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



Source: IMF Data, Advisory Team analysis.

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

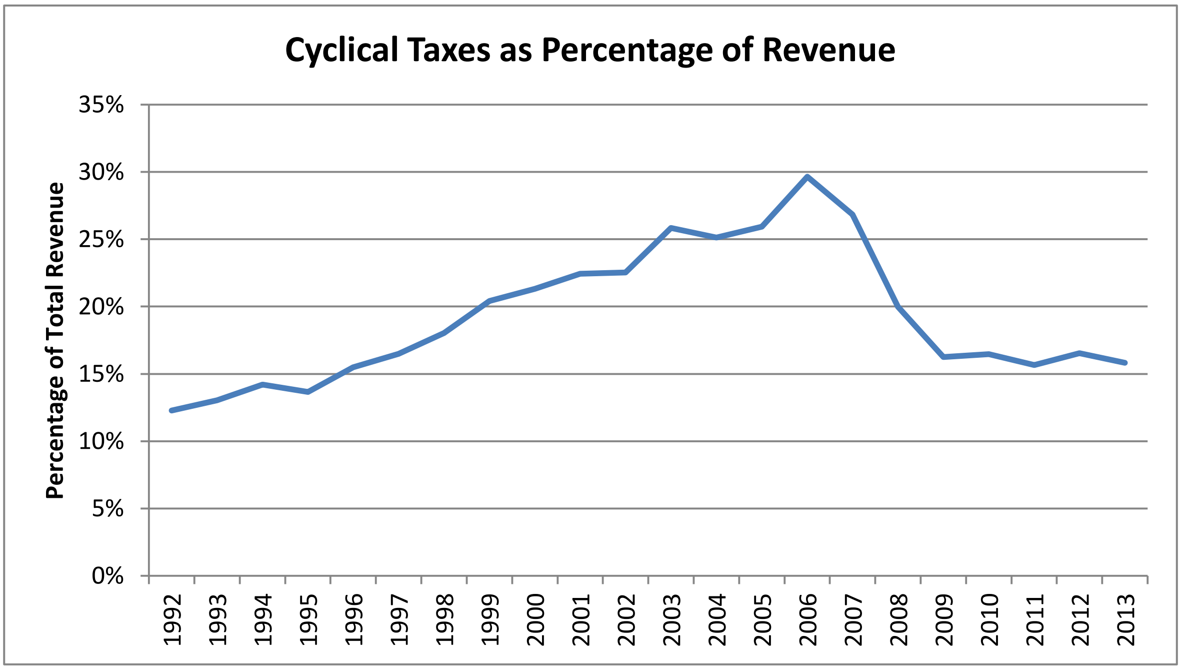


Source: IMF Data, Advisory Team analysis.

Note: Data available only from 1999 onwards.

Fiscal/Budgetary Policy

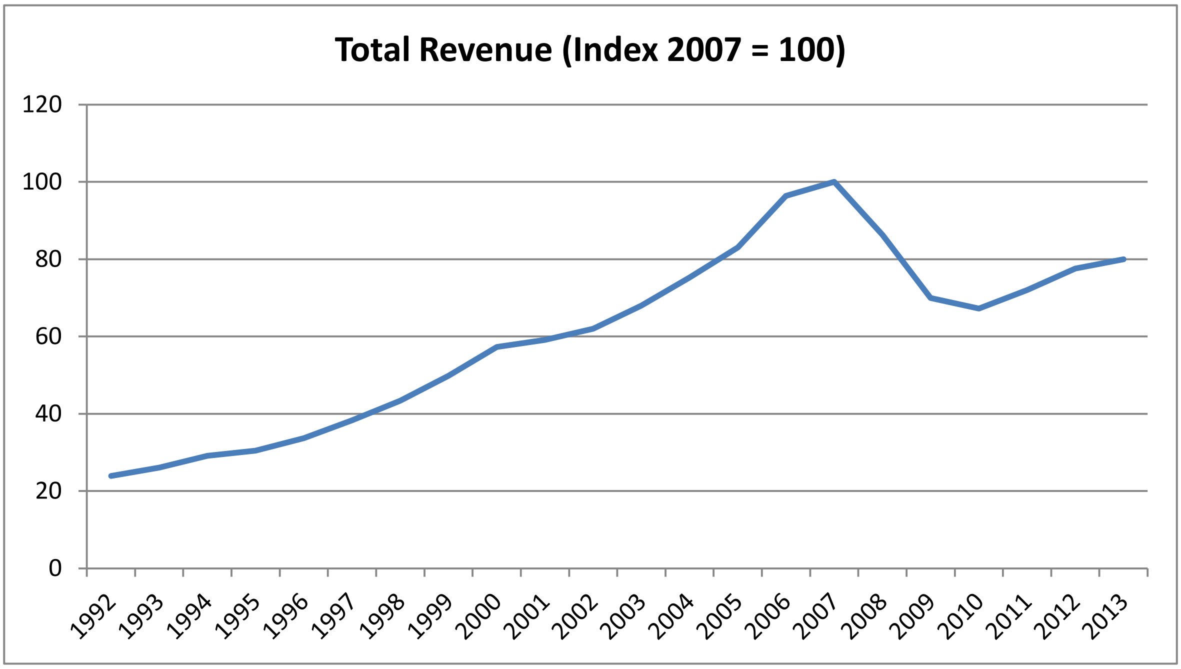
Figure 16: Cyclical Taxes as Percentage of Total Tax Revenue (1992 – 2013)



Source: Department of Finance data, Advisory Team analysis.

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

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



Source: Department of Finance data, Advisory Team analysis.

November 2004
IMF Country Report No. 04/349

Ireland: Selected Issues

The Selected Issues paper for Ireland was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on September 22, 2004. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of Ireland or the Executive Board of the IMF.

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Washington, D.C.

INTERNATIONAL MONETARY FUND

IRELAND

Selected Issues

Prepared by Keiko Honjo, Benjamin Hunt, Petya Koeva,
and Marialuz Moreno Badia (all EUR)

Approved by European Department

September 22, 2004

Boxes

Figures

Tables

I. Potential Growth After the Boom[1]

A. Introduction

1. **Ireland experienced a period of unprecedented growth in the 1990s, catching up and even overtaking other industrial countries on a per capita income basis** (see Table 1). Between 1993 and 2003, real income per capita rose by a cumulative 71 percent (94 percent), when GNP (GDP) is used as a measure of aggregate income. As a result of this impressive growth, Ireland's income levels mostly converged to those of other industrial countries on a per capita basis. In 2003, real GNP per capita in Ireland was about 99 percent of the EU average, while real GDP per capita was almost 20 percent above it.

Table 1. Average Annual Growth Rate of GDP per Capita 1/

	1961-70	1971-80	1981-90	1991-2000
Australia	3.4	1.5	1.5	2.3
Austria	4.1	3.5	2.1	1.9
Belgium	4.3	3.2	1.9	1.9
Canda	3.3	2.7	1.5	1.9
Denmark	3.9	1.6	1.6	1.9
Finland	4.4	3.5	2.6	1.6
France	4.5	2.7	2.0	1.5
Germany	3.5	2.6	2.0	0.5
Iceland	3.2	5.2	1.7	1.7
Ireland	**3.8**	**3.2**	**3.3**	**6.4**
Ireland (GNP)	**3.6**	**2.2**	**2.8**	**5.8**
Italy	5.0	3.2	2.2	1.4
Japan	9.0	3.3	3.4	1.2
Netherlands	3.7	2.1	1.7	2.3
New Zealand	1.8	0.7	1.2	1.5
Norway	3.4	4.3	2.2	3.1
Spain	6.3	2.5	2.6	2.4
Sweden	3.9	1.6	1.9	1.7
UK	2.3	1.9	2.4	2.2
US	2.9	2.2	2.2	2.3

Sources: AMECO, and staff calculations.
1/ In 1995 PPPs, US dollars.

2. **The main question addressed in this paper is how fast will Ireland grow in the future.** With the convergence process mostly complete, this is a difficult question to answer, as the past may not be the best guide to the future. Nevertheless, the approach of this paper is to consider the catch up in labor productivity and utilization and use independent demographic projections and other considerations in order to make reasonable assumptions about labor productivity and utilization growth in the future.

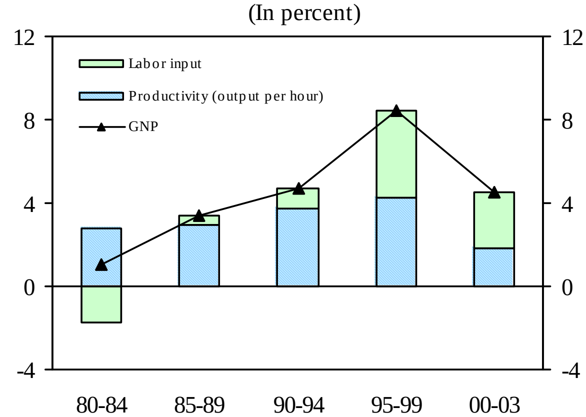
[1] Prepared by Petya Koeva and Marialuz Moreno Badia.

3. **The rest of the paper is organized as follows.** Using a simple growth-accounting framework, Section B discusses the trends in labor utilization and productivity per hour in the past. Section C presents our baseline projections for labor productivity growth and the components of labor utilization growth in the future. Section D concludes.

B. Decomposing Past Output Growth

4. **Ireland's impressive economic performance over the past decade raises the question of whether such a boom can be repeated in the future.** Although productivity growth (measured as output per hour worked) was strong throughout the period peaking at 4.2 percent a year during the mid-1990s—well above the productivity growth in most industrial countries—what set Ireland apart was the extraordinary increase in labor utilization during those years. Therefore, whether Ireland could replicate the remarkable boom of the 1990s largely depends on future trends in labor utilization. This section introduces a simple growth accounting framework to examine the sources of Ireland's growth in the late 1990s .

Decomposition of GNP Growth
(In percent)



Sources: Central Statistics Office; and OECD.

Growth-accounting framework

5. **Output growth can be decomposed into several components.** Using a simple identity, one can express output per capita (1) as the product of labor productivity per hour (2), average hours worked (3), the employment rate (4), the participation rate (5), and the inverse of the dependency ratio (6):

$$\frac{Y}{N} \equiv \left(\frac{Y}{L*h}\right)*\left(\frac{L*h}{L}\right)*\left(\frac{L}{Lf}\right)*\left(\frac{Lf}{Wp}\right)*\left(\frac{Wp}{N}\right)$$

(1) (2) (3) (4) (5) (6)

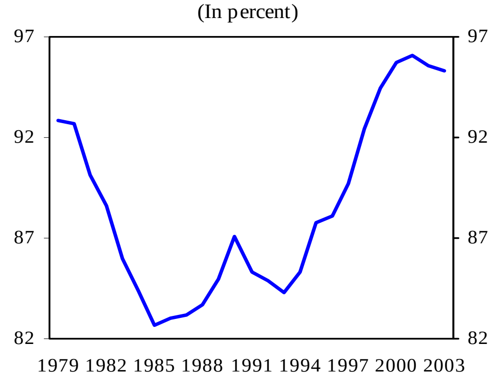
where Y is output, N is total population, Wp is working-age population, Lf is labor force, L is total employment, and h is average hours worked per employee. Therefore, per capita output growth is equal to the sum of labor productivity growth and the growth in the above four components of labor utilization (see (3)-(6)). By the same token, output growth can be calculated as the sum of labor productivity growth and the five components of labor utilization growth (average hours, employment rate, participation rate, inverse of dependency ratio, and population).

Past growth in labor utilization

6. **Similar to other industrial countries, average hours worked in Ireland have fallen steadily since the mid-1970s, which can be attributed to several factors** (see Figure 1). First, the rise in female participation, especially during the mid-1990s, led to a shift from full-time to part-time employment and was associated with fewer hours worked. Second, faster growth in services relative to the industrial and agricultural sectors has also contributed to the decline, given the greater use of part-time employment and fewer average hours worked in the service sector. Third, strong preference for leisure and the Working Time Act may help explain the decline in the average hours worked by full-time workers.[2]

7. **After sluggish performance during most of the 1980s, the employment rate started rising sharply in the early 1990s**. While a number of factors contributed to the lack of job creation during the 1980s, poor demand management policies are often cited as the primary reason, resulting in high taxes and interest rates.[3] Faced with unemployment rates of over 16 percent, the social partners—employees, employers and the government—decided to adopt a cooperative approach to wage setting in the late 1980s, based on trading wage moderation and industrial peace for tax cuts and social welfare improvements. While not the only factor, the social partnership contributed significantly to the increase in the employment rate since the early 1990s, which averaged 2.1 percent per annum during the second half of the 1990s.

Employment Rate
(In percent)



Source: Central Statistics Office.

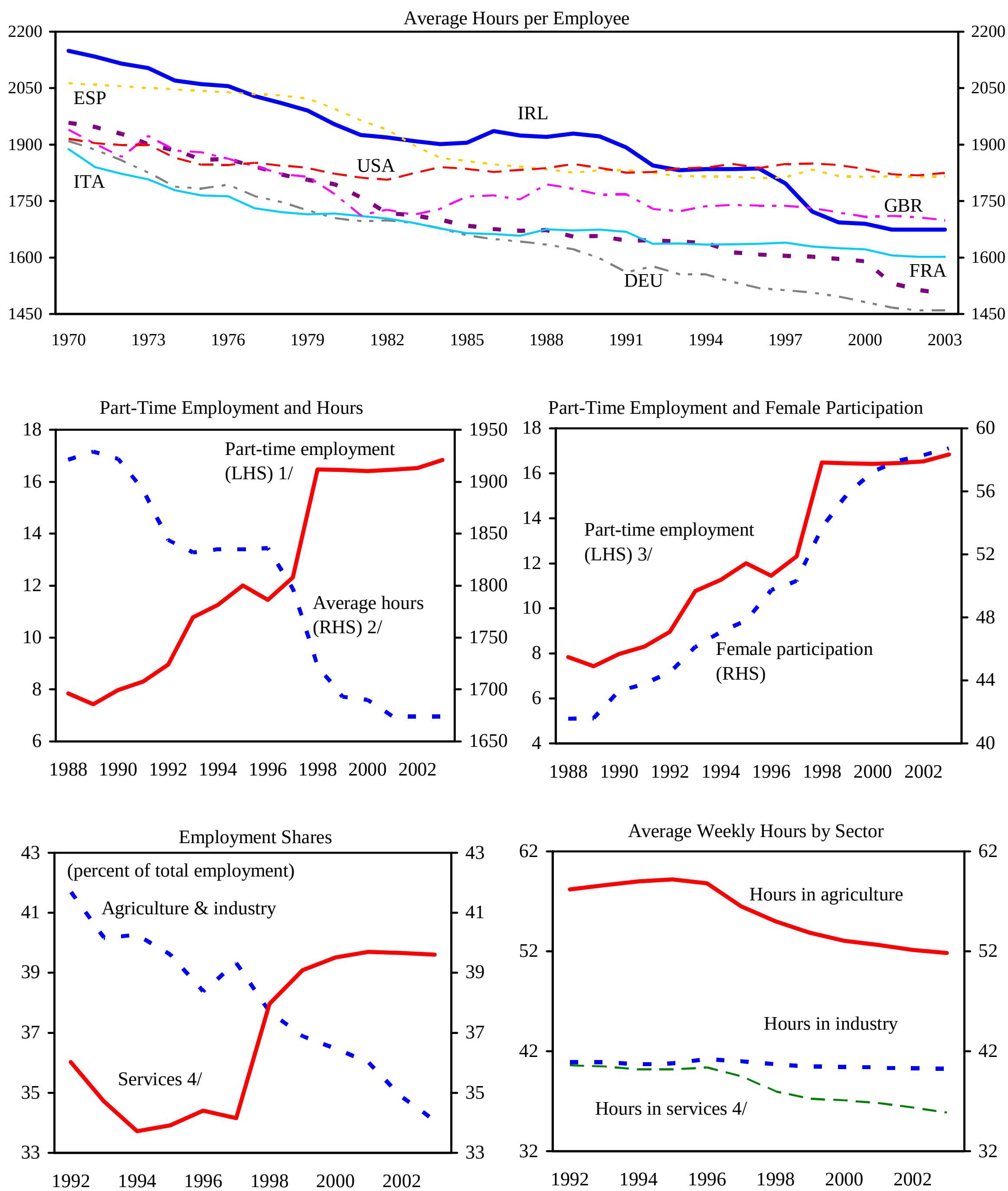
8. **The participation rate also picked up, mainly reflecting higher female participation**. Following a steady decline from the mid 1960s to the late 1980s, the participation rate started increasing in the early 1990s. This increase was mainly driven by

---

[2] The Organization of Working Time Act was introduced in 1997 to provide for the implementation of Directive 93/104/EC of 23 November 1993 of the Council of the European Communities concerning certain aspects of the organization of working time. It established a maximum of 48 hour working week averaged over a reference period; a minimum daily rest period of 11 consecutive hours a day; a rest break where the working day is longer than four hours; a minimum rest period of one day a week; a statutory right to annual paid holiday of four weeks; and a maximum night working time of eight hours a night, on average.

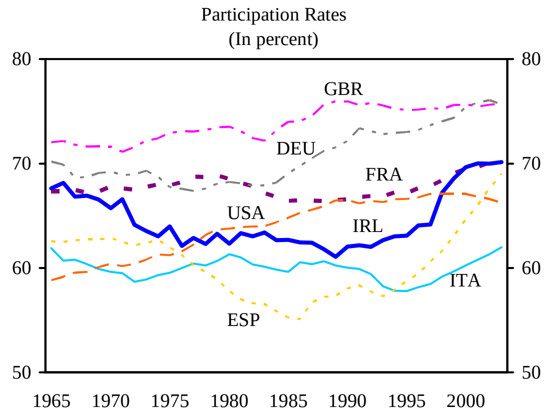
[3] See Honohan and Walsh (2002).

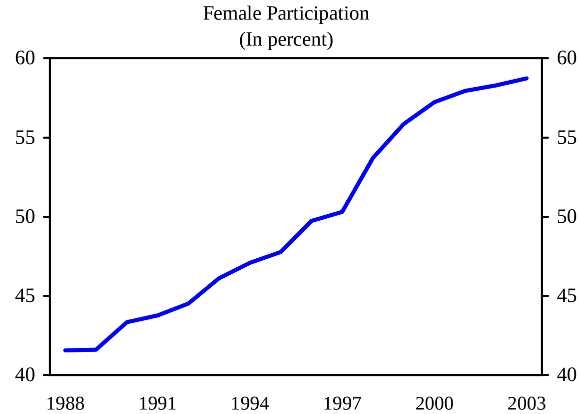
Figure 1. Ireland: Factors Explaining Average Hours



Sources: CSO, Eurostat, and OECD.
1/ Share of part-time in employment in percent.
2/ Average hours worked per employee.
3/ Share of part-time employment in percent.
4/ Services excluding public administration.

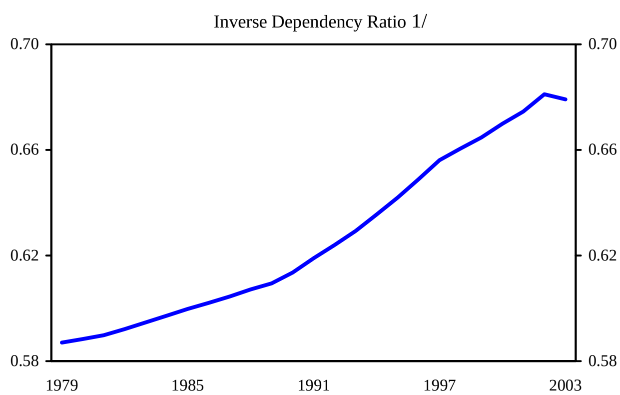
higher female participation, which, in turn, reflected better job opportunities as a result of the improving economy. Male participation also rose in the 1990s, albeit at a much slower pace.



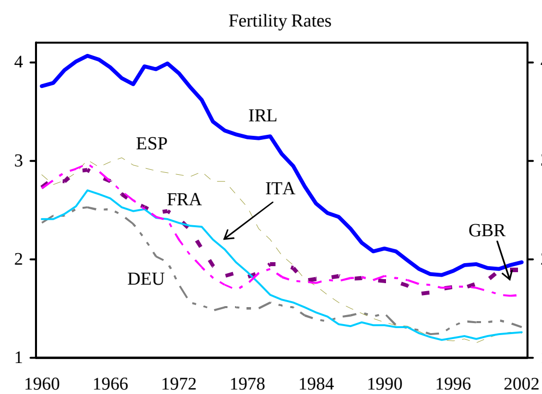


Sources: Central Statistics Office; and OECD.

9. **Providing an additional boost to economic growth, the inverse dependency ratio increased substantially, reflecting favorable demographic factors**. In contrast to other European countries, fertility rates in Ireland were very high in the 1960s and 1970s. As a result, the working-age population increased significantly in the 1980s and 1990s, prompting a steady rise in the inverse dependency ratio.



Sources: Central Statistics Office; and staff calculations.
1/ Working -age population over total population.



Source: Eurostat.

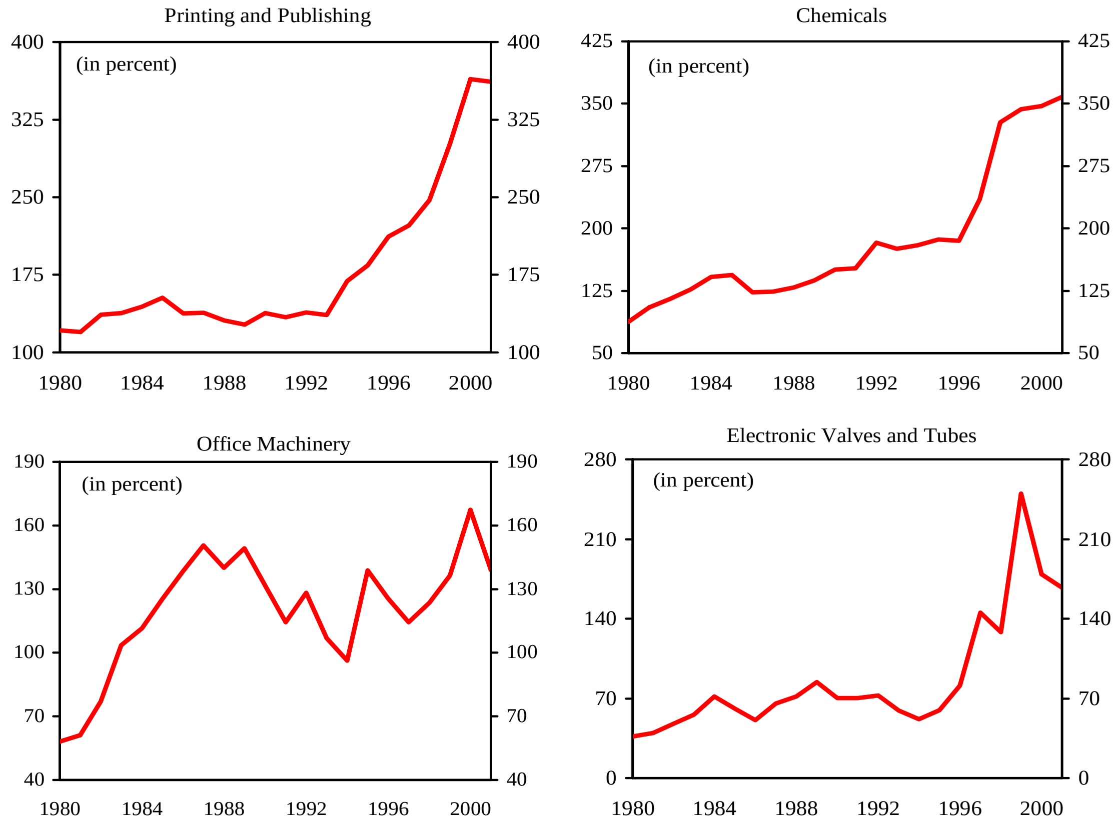
10. **Population growth also supported the increase in output, helped by a reversal of migration flows**. In addition to Ireland's higher fertility rates, the turnaround in migration flows also played an important role in boosting population growth, starting in the mid 1990s. The net inflow of migrants to Ireland between 1996 and 2003 was close to 0.2 million (compared to a total population of about 4 million in 2003).

Past growth in labor productivity per hour

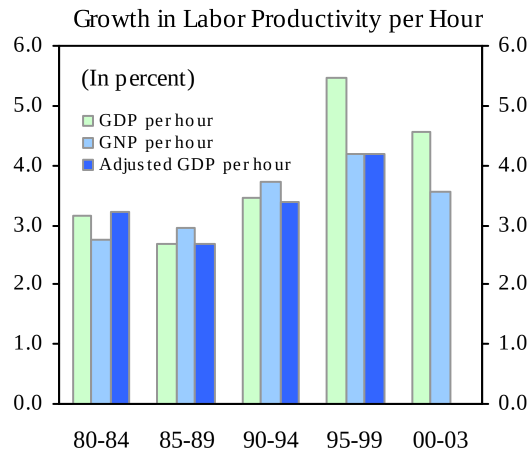
11. **In Ireland, labor productivity is notoriously difficult to measure, given the distortions to sectoral output caused by the operations of multinational companies.** It is a well known fact that the level and growth in labor productivity in Ireland has been higher in industries dominated by foreign companies. And while this superior performance during the 1990s also reflected true productivity improvements (as a result of the surge in FDI and the associated technology transfer), a nontrivial part of it was due to monopoly (or patent-related) profits of multinational companies that were booked in Ireland, given its low corporation tax rate regime. In other words, as Honohan and Walsh (2002) point out, *"...in many cases, the huge profits recorded by the Irish affiliates* [had] *very little to do with the manufacturing activities being conducted in Ireland"*, but rather emerged as a consequence of transfer pricing. In this context, it is not surprising that capturing true productivity growth in Ireland has been a major challenge. In this section, we consider three measures of aggregate labor productivity—GDP per hour, GNP per hour, and adjusted GDP per hour. The unadjusted GDP measure includes the profits of foreign-owned firms operating in Ireland, while the GNP measure excludes them. The construction of the adjusted GDP measure is described below.

12. **How can we make an adjustment for the impact of the multinational sector on measured productivity?** To start, we compare Ireland's labor productivity levels in four industries dominated by multinationals—*chemicals, printing and publishing*, *office machinery*, and *electronic valves and tubes*—to the average productivity levels of the same industries in the EU.[4] As expected, productivity levels in these industries— particularly in *chemicals* and *printing and publishing*—rose much faster in the 1990s than in any other country. For example, measured labor productivity in Ireland's chemical industry, which exceeded the EU average by about 150 percent in 1990, shot up to over 350 percent in 2001! The corresponding figures for the printing and publishing industry are similar. Then, to adjust for labor productivity distortions, we assume that in the absence of the multinational sector in the second part of the 1990s, Ireland's productivity per hour in these two industries would have grown at the highest rate observed across all other countries in the sample.

[4] We use the *Industry Labour Productivity Database* by O'Mahony and van Ark (2003), which contains data on labor productivity per hour in EU countries and the US from 1979 to 2001. The database covers 57 industries, including services.



13. **Labor productivity growth depends on which measure of productivity is used to construct it**. Prior to the mid-1990s, the difference between the alternative measures does not, on average, exceed 0.5 percentage points. However, in the period from 1995 to 1999, the gap between the growth rates of GNP per hour (4.2 percent) and adjusted GDP per hour (4.2 percent) and the growth rate of GDP per hour (5.5) is particularly stark. In other words, the GNP and adjusted GDP measures indicate a substantially lower productivity growth in the second half of the 1990s than the GDP measure.



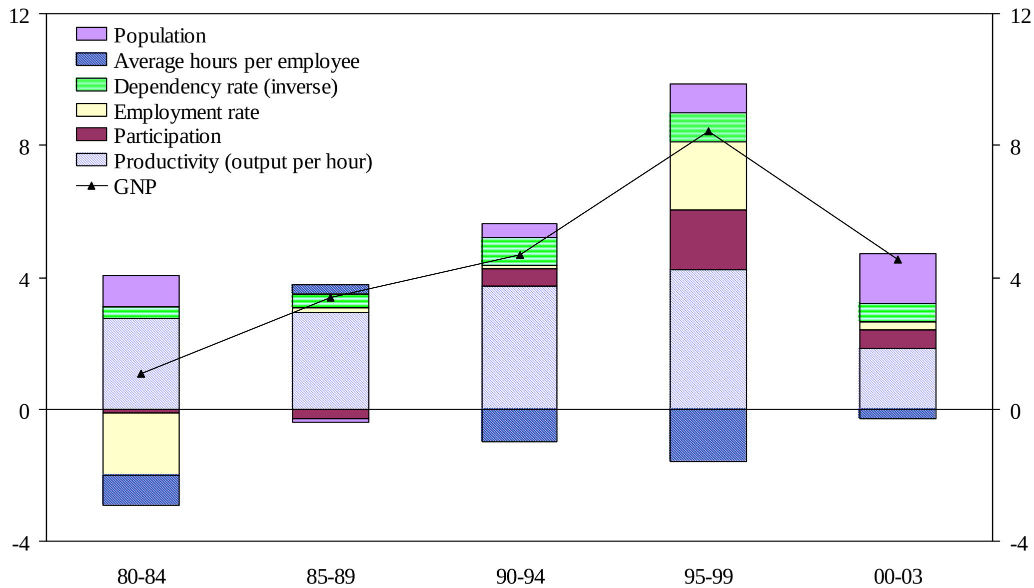
14. **In the remaining part of the paper, we focus on GNP per hour as the most appropriate measure of productivity, given the problems associated with the other two measures**. The use of unadjusted GDP is clearly inappropriate as already suggested in para 10. As far as adjusted GDP is concerned, there are a number of other assumptions that

one could make about counterfactual developments in the industries dominated by multinational companies. Unfortunately, the adjusted GDP measure is not robust to the specific assumption of what Irish productivity growth would have been in the multinational-dominated industries if the foreign companies had not entered the Irish market, as the magnitude of the adjustment could change substantially under alternative assumptions. Hence, we are left with GNP per hour as a more suitable measure of productivity than its two alternatives.

Past growth in output

15. **The decomposition of GNP growth illustrates that higher growth in both labor productivity and labor utilization explain Ireland's boom in the 1990s**. Putting together the components of output growth discussed in this section shows the relative contributions to GNP growth of the variables discussed in this section. During the second half of the 1990s, productivity growth accounted for slightly higher than ½ of the overall growth rate, while the sharp rise in employment and participation rates was mainly responsible for the rest.

Decomposition of GNP Growth
(In percent)



Sources: Central Statistics Office; and OECD.

C. Aggregating Future Output Growth

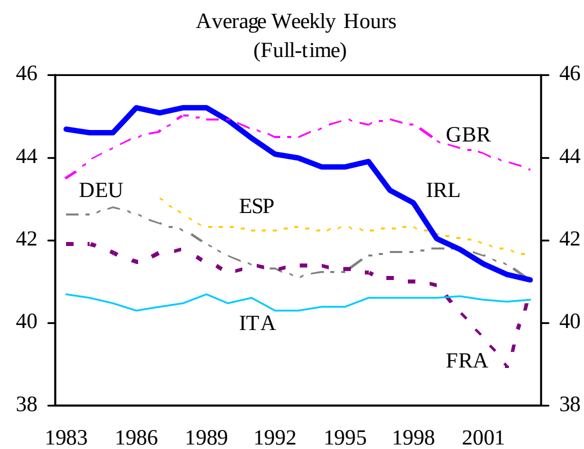
Future growth in labor productivity per hour

16. **Using the appropriate measure of output, Ireland's hourly productivity level still has room to catch up with those of the leaders**. In 2003, GNP per hour in Ireland was about 90 percent of the corresponding level in the US.[5] Therefore, it is reasonable to allow for a further convergence in the Irish productivity level and assume that the country's productivity growth would continue to exceed that of the US during the next decade.

17. **To allow for further convergence in labor productivity levels, we assume a prospective growth rate in trend productivity of 3 percent**. This is based on the expectation that prospective hourly labor productivity growth in the US is 2 percent (which is consistent with its recent performance) and that Ireland continues to close the gap in productivity levels at a rate of 1 percent per annum. In the context of its historical performance, the assumed GNP per hour growth of 3 percent growth is about ½ percent lower than in 1990-2003 and 1½ percent lower than during the boom period, 1995–2000.

Future growth in labor utilization

18. **Going forward, average hours worked are expected to be broadly stable**. Most of the factors contributing to the reduction in average hours worked in the 1990s appear to have run their course. In particular, the increase in part-time employment seems to have petered out. Given the limited scope for further increases in female participation, we expect part-time employment to remain broadly stable as a proportion of total employment. Average full-time hours are also assumed to stabilize at around 41 hours a week, barring new labor legislation and reflecting weaker income effects. The dynamics of hours worked in recent years seem consistent with the assumption of no trend in average hours worked in the future. However, a further compositional shift in employment towards services, leading to an additional decline in average hours worked, may be a downside risk to our baseline assumption.



Source: Eurostat.

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[5] In the same year, Ireland's GDP-based hourly productivity level surpassed that of the US.

19. **The employment rate is assumed to increase modestly**. Future trends in the employment rate are determined by prospective developments in labor supply and employment. On labor supply, our projections are based on the latest estimates made by the Economic and Social Research Institute (ESRI), which show a strong growth of about 2 percent per annum until 2010 and a somewhat slower growth of 0.9 percent per annum afterwards.[6] On employment, we also use the ESRI medium-term projections, which indicate an average growth rate of over 2 percent per annum until 2010 and a more modest growth of 1.1 percent per annum in later years. Therefore, we assume employment growth of 1.5 percent on average up to 2015, consistent with a NAIRU estimate of 4 percent, while labor force average growth is projected at 1.45 percent. Hence, our assumptions imply an annual growth in the employment rate of 0.05 percent per annum—substantially lower than that during the Celtic Tiger era.

20. **The participation rate is expected to rise further but at a slower rate, consistent with falling fertility rates and declining immigration flows**. Prospective growth in the participation rate depends on future growth in labor supply and working-age population. On labor supply, we use the assumptions already described in para. 19. On working-age population, we use the ESRI's assumptions of an average growth of 0.8 percent in the period up to 2015, consistent with slowing fertility rates and stabilizing net migration to 10,000 persons by 2015. Consequently, average growth in the participation rate is projected to be about 0.65 percent per annum until 2015.

21. **The inverse dependency ratio is assumed to decline slightly**. Growth in the inverse dependency ratio reflects the differential growth rates of working-age and total population. As discussed in para. 20, the prospective growth of working-age population is taken to be 0.8 percent per annum. Therefore, we project the inverse dependency ratio to decrease by 0.35 percent per annum, consistent with a population growth of about 1.15 percent.

22. **Population growth is projected to slow down**. While estimates of future population growth differ across institutions, its slowdown is undisputable (see Table 2). Over the medium-term, population growth is expected to slow down, reflecting a decline in fertility rates and a stabilization in net migration. As already mentioned in para. 21, we assume that Ireland's population grows by an average of 1.15 percent per annum until 2015 in line with the ESRI's estimates.

---

[6] See Bergin, A. and others (2003).

Table 2. Population Estimates
(Average annual growth rate, in percent)

	Circa 2015	Circa 2030	Circa 2050
CSO 1/	0.6	0.2	...
Eurostat 2/	0.7	0.4	0.0
EPC 3/	1.0	0.4	0.0
ESRI 4/	1.0	...	...
OECD 5/	0.5	0.2	-0.6
UN 6/	0.8	0.4	0.1

1/ Central Statistics Offi ce (2001), M1F2 scenario.
2/ Baseline scenario, 1999.
3/ Economic Policy Committee (2001).
4/ Bergin, A. and others (2003)
5/ OECD (2003)
6/ Database for United Nations (2003).

Future growth in potential output

23. **Aggregating its components, we project potential GNP growth of 4½ percent in the medium run**. The baseline projections for labor productivity per hour and the five components of labor utilization are summarized in Table 3. As already suggested in the previous section, labor supply growth was the most important factor explaining the pick up in output growth during the mid-1990s. In the absence of a similar increase in labor supply over the next decade the projected trend growth is 4½ percent.

Table 3. Decomposition of Potential Growth
(In percent)

Productivity	3.00
Average hours	0.00
Employment	0.05
Participation	0.65
Inverse dependency	-0.35
Population	1.15
Potential output	4.50

Source: Staff calculations

D. Concluding Remarks

24. **This paper presents a projection for Ireland's potential growth over the next decade and explains its underlying assumptions.** Using a simple growth accounting framework, we make reasonable assumptions about future growth in labor productivity, average hours worked, employment and participation rates, the inverse dependency ratio, and population. Adding up these components, we arrive at an estimate of potential output growth of 4½ percent over the medium run.

25. **Nonetheless, there are significant, mostly downside risks to our baseline projection for potential growth**. First, productivity growth may be lower than 3 percent, particularly if Ireland loses its attractiveness as a destination for FDI. Second, hours worked may continue to fall, reflecting stronger-than-expected income effects and preference for leisure. Third, migration flows may be lower than expected, especially if high property prices act as a constraining force on labor supply. Finally, female participation may reverse its historical trend and decline, particularly if childcare costs continue to rise relative to wages.

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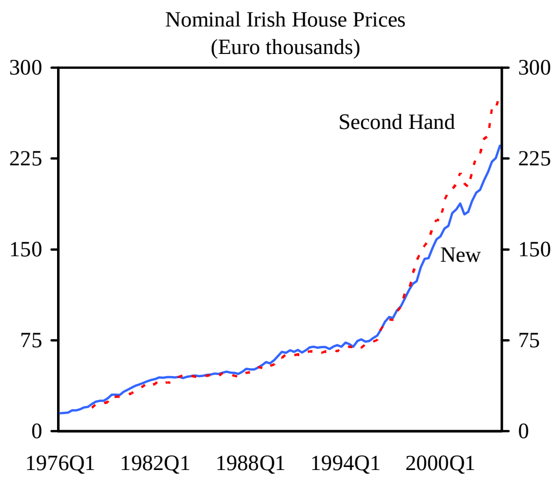
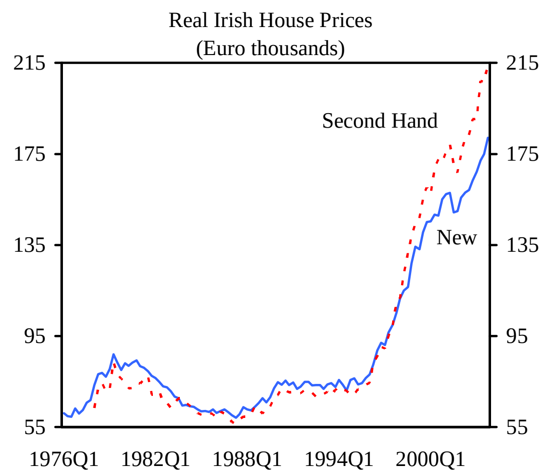
II. Adjustment in the Housing Market[1]

A. Introduction

1. **Ireland's house prices have risen dramatically since the mid-1990s, despite an interim deceleration.** From 1993 to 2003, the price of new houses posted a cumulative increase of about 140 percent in real terms (220 percent in nominal terms). During the same period, the corresponding price increase of second hand houses was almost 200 percent in real terms (300 percent in nominal terms). The boom has been particularly pronounced in Dublin, where real house prices have more than tripled over the past decade. Although the strong surge in the housing market did moderate for a short period in the late 1990s—real price increases of both new and second hand houses declined from over 20 percent in 1998 to around 3 percent in 2001—house price inflation reignited in 2002 and reached 11½ percent in 2003.





Sources: The Department of Environment, Heritage and Local Government, OECD, and staff calculations.

2. **The sheer length and magnitude of the Irish house price boom have prompted both the natural question of its sustainability and a wide spectrum of views in response.** A number of external observers, such as the IMF (2003) and the Economist (2003), have argued that Irish house prices are significantly overvalued (by as much as 40–50 percent). In Ireland, some commentators have also cautioned that the longer prices continue rising, the higher the probability of a disruptive adjustment in the housing market (Davy Stockbrokers, 2003; Central Bank of Ireland, 2003). At the other end of the spectrum, Roche (2003) and

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[1] Prepared by Petya Koeva and Marialuz Moreno Badia. We thank Kieran McQuinn for providing data on the Irish housing market, as well as for his valuable comments.

McQuinn (2004) have contended that there is no evidence of overvaluation in the housing market.

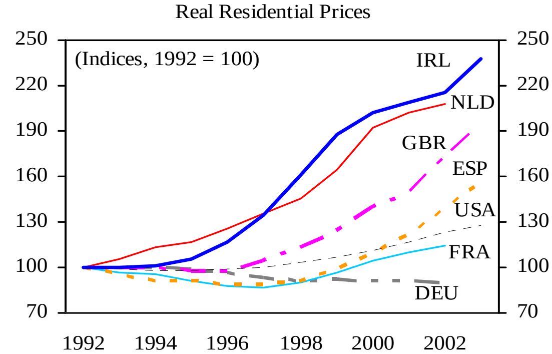
3. **The purpose of this paper is threefold.** First, it describes the spectacular boom of the Irish housing market and its key drivers from an international perspective. Second, the paper presents analytical and descriptive evidence on whether recent house price increases can be fully justified by fundamentals and discusses whether house prices and expectations have adjusted to the new environment of lower income growth. Finally, it raises a number of questions about the Irish housing market, including its linkages with the rest of the economy.

4. **The rest of the paper is organized as follows**. Section B compares the performance of Ireland's housing market with those in other industrial countries and highlights key developments in demand and supply that have the potential to explain it. Section C examines *analytical* evidence (based on alternative valuation methods) on whether the surge in house prices can be justified by fundamentals only. Section D presents *descriptive* evidence (from developments in the buy-to-let and second-home market, the market response to policy changes, and survey responses) on whether other factors could be affecting the recent dynamics of Irish house prices. Section E draws preliminary conclusions and raises questions about the impact that a housing market adjustment would have on the economy.

B. The Irish Boom in Context

5. **Although many industrial countries have experienced sharp house price increases since the mid-1990s, the magnitude of the Irish boom has been unsurpassed.** Between 1995 and 2003, real house prices in Ireland rose by an average of 10.7 percent per year, exceeding even the annual growth rates in other industrial countries with strong house price inflation, such as the United Kingdom (8.5 percent), the Netherlands (8.6 percent), and Spain (7 percent).

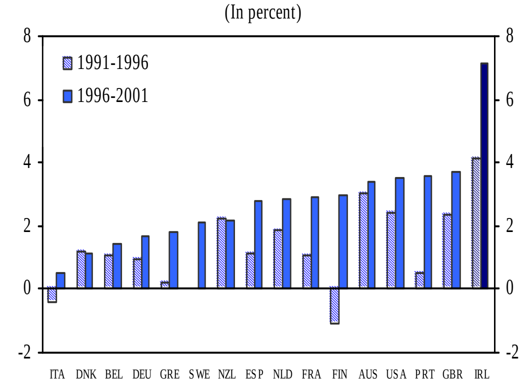
Real Residential Prices



Sources: BIS, staff estimates.

Average Annual Growth in Disposable Income

(In percent)



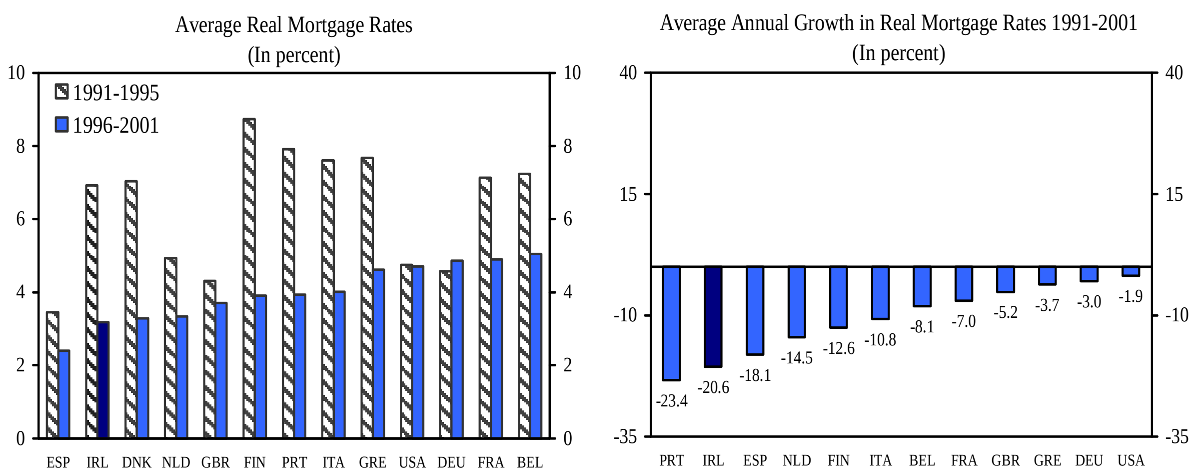
Source: OECD.

6. Perhaps the surge in Irish house prices can be attributed to more favorable demand factors. A number of facts point in this direction:

- *Growth in real disposable income* in Ireland since the mid-1990s has been stronger than in any other industrial country, thereby boosting housing demand. Between 1996 and 2001, the average annual growth rate in Ireland was

7.2 percent, compared with 2.5 percent in the European Union and 3.5 percent in the United States.

- *Real mortgage interest rates* in Ireland in the late 1990s were among the lowest among industrial countries, providing additional support to housing demand. In addition, the decline in Ireland's real mortgage rates since the first half of the 1990s has been more pronounced than in many other countries.



Sources: Ameco, CSO, European Federation of Mortgage Lenders, OECD, and staff calculations.

- *Financial market liberalization* during the 1980s and 1990s has also supported demand by allowing a rapid expansion in credit (Table 1). The strong growth in household credit, averaging 20 percent a year since 1995, has resulted in a doubling of household debt relative to disposable income since the mid-1990s. In fact, mortgage credit alone accounts now for about 80 percent of household credit or 77 percent of household disposable income.[2]

[2] See Kelly, J. (2004).

Table 1. Financial Market Liberalization in Ireland

Year	Measure
1980	Daily interbank settlement facilities provided by Central Bank.
1983	Introduction of sale and repurchase agreements for supplying liquidity to interbank market.
1984	Formal guidelines for bank lending to private-sector ended.
1985	New interest-rate arrangements facilitate greater competition among banks at retail level.
1986	Issue of indicative sectoral credit guidelines ended.
1987	Announcement of Government intention to establish IFSC.
1988	Major relaxation of exchange controls.
1991	Formal trigger mechanism for changes in retail interest rates suspended. Primary liquidity ratio reduced to 8 percent.
1992	Reduction in primary liquidity ratio to 6 percent. Limitation on foreign exchange borrowing by residents and domestic currency borrowing by non-residents removed.
1993	Reduction in primary liquidity ratio to 4 percent. Fixed-rate mortgages introduced by some banks for first time.
1994	Reduction in primary liquidity ratio to 3 percent. Secondary liquidity requirement abolished.
1999	Reduction in primary liquidity ratio to 2 percent.

Source: Browne, F., Gavin, D. and A. Reilly (2003).

- *Demographic trends* in Ireland were particularly favorable to housing demand in the 1990s (Figure 1). The growth rate of household formation in Ireland exceeded those in other industrial countries, mostly reflecting rapid growth in the population aged 25 to 34 (the first-time buyer group) and stronger migration inflows.

- *The tax treatment of housing* in Ireland has been more supportive of home ownership than in most other EU countries (Table 2). In particular, the existence of mortgage interest relief, the absence of a tax on imputed rent, and the exemption from capital gains tax on principal dwellings have contributed to a lower user cost of housing, thereby reinforcing housing demand.

Table 2: Housing Taxes in European Countries (2001)

	Tax on imputed rent	Interest relief 1/	Tax on capital gain	Real estate tax
Denmark	Y	Y	Y (tax exemptions for owner-occupied)	Y
Germany	N	N	Y (turnover<10 years, tax exemptions for owner-occupied)	N (land tax, 0.3-1% of rateable values)
Greece	Y 2/	Y 2/	N	0.025% to 0.035%; for large estates: 0.3% to 0.8%
Spain	N (for primary houses)	Y	Y (tax exemptions for principal dwellings when reinvested)	0.62
France	N	N	Y (no tax for main residence)	+ residence tax; 7.8%-45% of half cadastral rental value
Ireland	N	Y	Y (tax exemptions for principal dwellings)	N
Italy	Y 3/	Y 4/	Y (50% tax reduction for pood)	0.4%-0.7% of cadastral value
Netherlands	Y	Y	N	0.3%
Sweden	Y	Y	Y (25%)	0% to 1.5% of 75% of the market value price
United Kingdom	N	N	Y (tax exemtion for pood)	0.2%

Source: European Central Bank (2003).

1/ Mortgage-related.

2/ For principal owner-occupied dwelling.

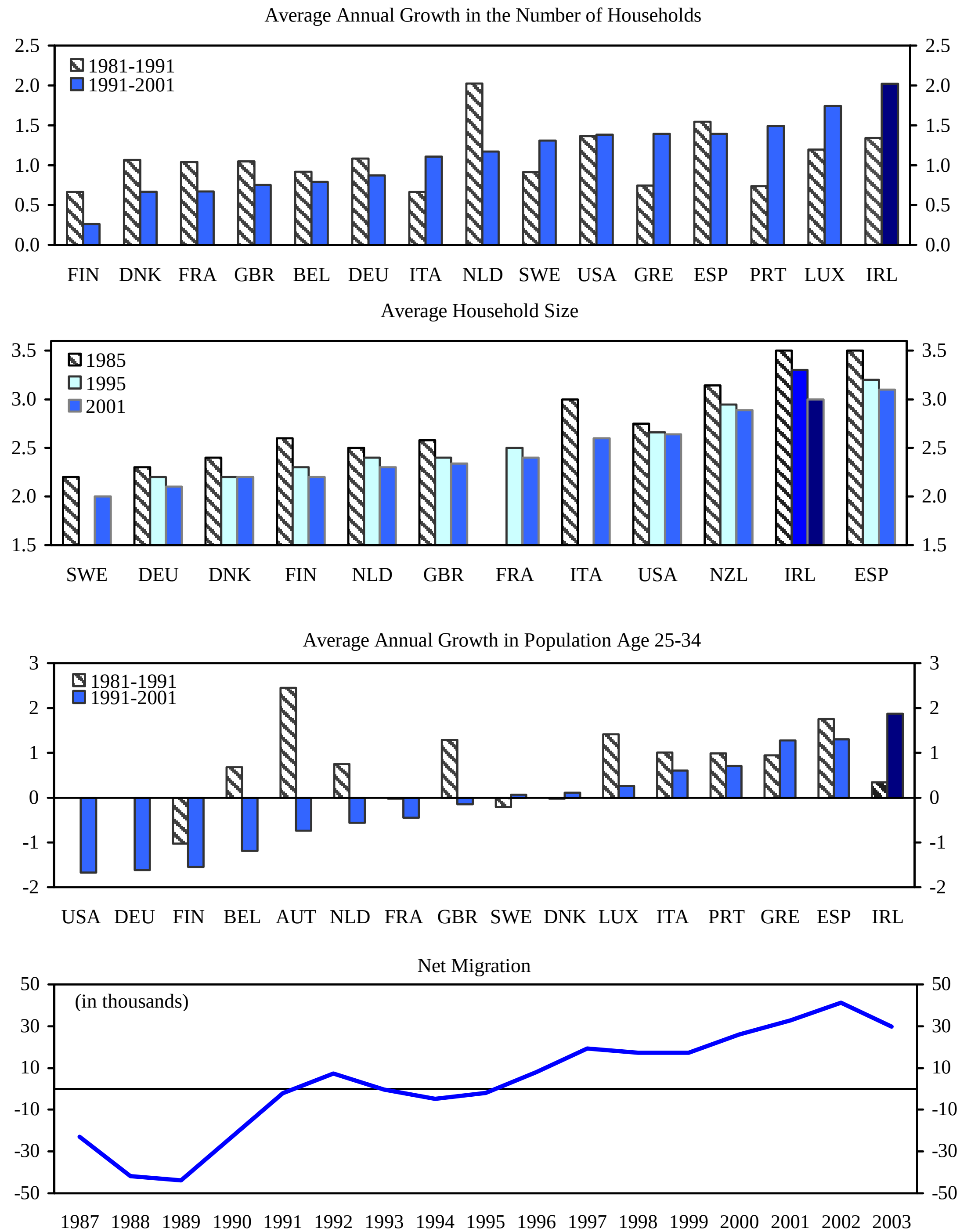
3/ Exemption for principal owner-occupied dwelling.

4/ Only for principal owner-occupied dwelling.

Y: Yes.

N: No.

Figure 1. Ireland: Demographics



Sources: CSO, EuroStat, Housing Statistics in the European Union 2002, National Statistical Offices, and ODPM.

- *Mortgage finance* in Ireland has been less restrictive than in most other EU countries. For example, the maximum loan-to-value ratio is 90 percent, exceeding even those in the United States, Australia, Spain, and the Netherlands (Table 3).

Table 3: Maximum Loan to Value Ratio
(in percentage)

Australia	80
Belgium	80-85
Canada	75
Denmark	80
Finland	75
France	80
Germany	60
Ireland	90
Italy	50
Japan	80
Netherlands	75
Norway	80
Spain	80
Sweden	80
Switzeland	66
United Kingdom	90-100
United States	75-80

Source: Tsatsaronis and Zhu (2004).

7. **The rise in housing demand triggered a response in housing supply unprecedented by international standards (Figure 2).** A number of measures illustrate this trend:

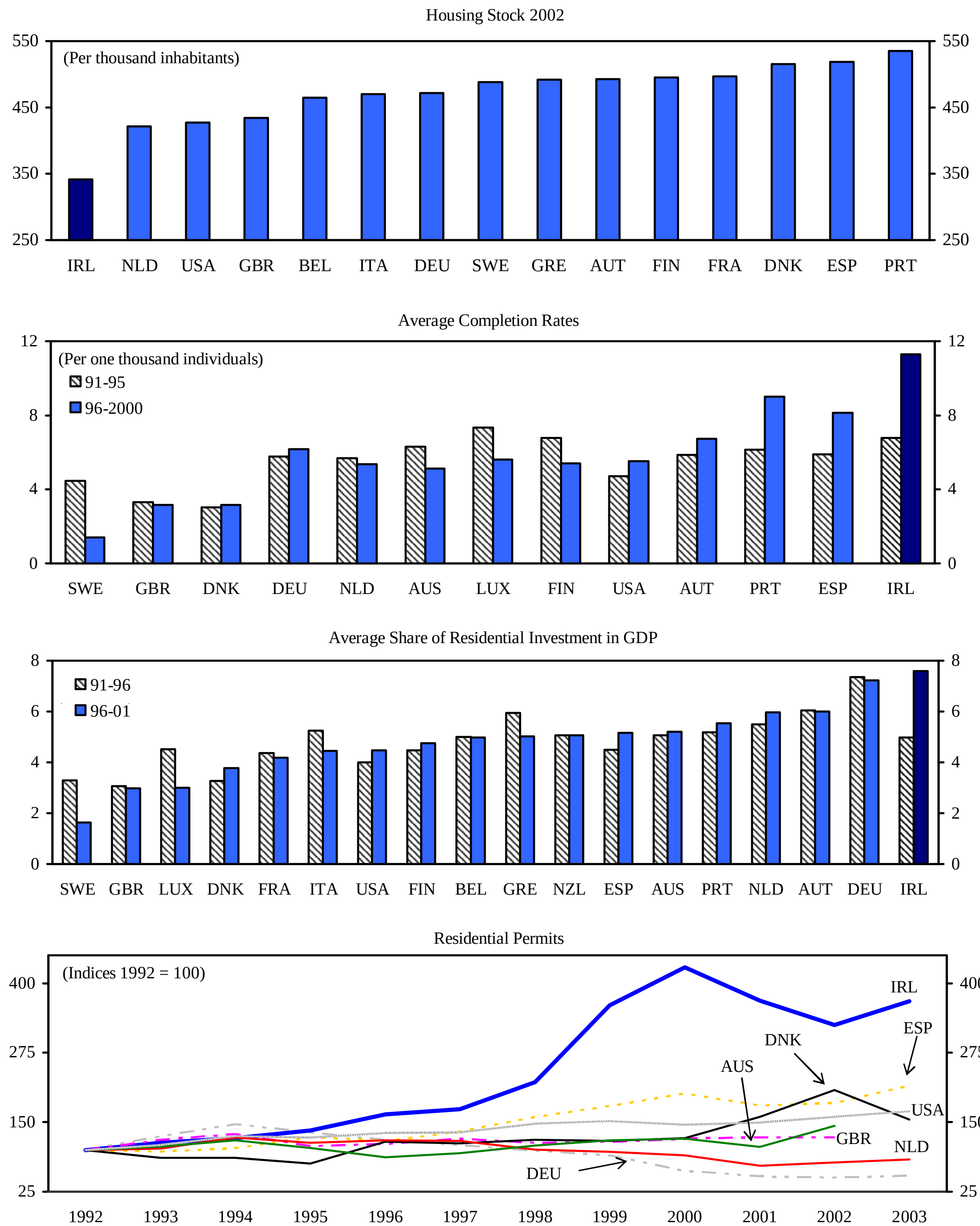
- Over 420,000 new houses were completed in Ireland between 1995 and 2003. The number of house completions reached an all-time high of 69,000 units in 2003, posting a year-on-year growth of close to 20 percent.

- The average implied house completion rate (per thousand people) was higher than in any other industrial country between 1996 and 2000. As a proportion of the existing housing stock, the number of house completions in 2001 was about three times higher than in other housing-boom countries, such as Spain and the United Kingdom.

- On average, residential investment between 1996 and 2001 constituted a higher share of GDP (over 7 percent) in Ireland than in any other industrial country.

- The number of housing permits issued rose by over 80 percent between 1995 and 2001.

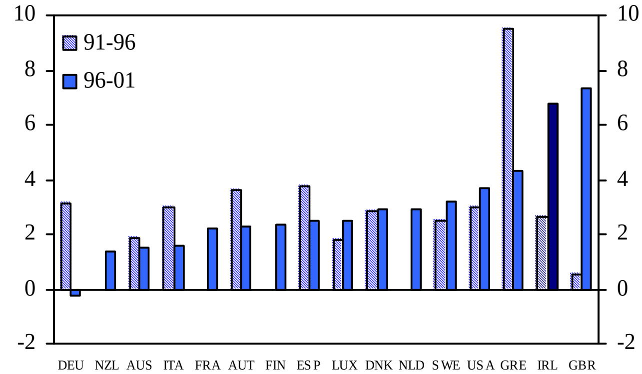
Figure 2. Ireland: Housing Supply



Sources: Ameco, DataStream, Department of Environment, Heritage and Local Government, Eurostat, European Federation of Mortgage Lenders, National Statistical Offices, ODPM, and staff calculations.

8. **Partly stimulated by supportive government policies, the enormous increase in housing supply was accompanied by significant increases in real construction costs and land prices.** The cost of house construction rose by an average of 2½ percent in real terms between 1995 and 2002, but declined by almost 1 percent in 2003. Land prices are estimated to have grown by an average of 25 percent in real terms between 1995 and 2001, but to have remained broadly flat in 2002. The significant cost increases did not deter the supply of new housing, which was also aided by policy measures to increase the availability of land for residential development and to relax zoning regulations, as well as to allow higher densities at desirable locations.

Average Annual Growth in Construction Cost
(In percent)



C. Analytical Evidence

9. **The question of whether the above fundamentals fully explain the Irish housing boom can be addressed by using two alternative valuation methods.** The first approach is to estimate an econometric model of house prices as a function of supply and demand factors and examine whether the actual house prices deviate from their long-term equilibrium values. The second approach is to treat housing as an asset that reflects the discounted present value of its future "dividends," which should be driven by fundamentals, and construct its price-to-earnings ratio.

Econometric model of house prices

10. **In its generic form, the econometric model is a reduced-form equation of house prices as a function of demand and supply variables.** The starting point is a system of two structural (supply and demand) equations, which is transformed into a reduced-form equation:

- The *structural demand equation* is given by $Q_t^d = f(P_t, X_t^d)$, where Q_t^d is housing demand, P_t is the real house price, and X_t^d is a vector of demand-shifting variables, such as disposable income, the user cost of housing (mortgage rate, taxation), demographics, etc. Some econometric specifications are based on this equation. After reversing the positions of housing demand and prices, one obtains an *inverted-demand equation,* linking house prices to the demand variables X_t^d and the housing stock.

- The *structural supply equation* is given by $Q_t^s = f(P_t, X_t^s)$, where Q_t^s is housing supply, P_t is the real house price, and X_t^s is a vector of supply-shifting variables, such as zoning restrictions, real construction costs, land prices, etc.

- The *reduced-form equation* for the equilibrium house price, $P_t = g(X_t^d, X_t^s)$, is obtained by equating supply and demand. In other words, the equilibrium price depends on all variables that affect housing supply and demand. The house price equation is typically estimated using an error-correction model. Actual house prices are then compared with the estimated equilibrium prices, which are consistent with the (supply and demand) fundamentals included in the model.

11. **Empirical analyses focusing on demand-side factors generally find that house prices in Ireland are significantly overvalued:**

- A background note for the 2003 Article IV consultation with Ireland estimated a reduced-form equation of real annual house prices as a function of disposable income, real mortgage rates, and the share of households aged 25-35. If the equation was estimated for the period 1976-2002, the actual house price was about 16½ percent higher than its long-run equilibrium. However, the deviation of the actual house price from the equilibrium price (implied by fundamentals) was over 50 percent when the model was estimated for the period 1976-97.

- Bacon and MacCabe (2000) estimated an inverted-demand equation for the period 1972-96, including variables such as demographics, disposable income, mortgage rates, and housing stock. Using the estimated parameters to compute the predicted prices for 1997-2000, the authors established that the actual house price in 2000 deviated from its fundamental value by over 85 percent.

- Based on the deviation of the price-to-income ratio from its long-run trend, *the Economist* (2003) concluded that Irish house prices were overvalued by over 40 percent.[3]

12. **If certain supply factors are included in the model, the estimated degree of overvaluation declines dramatically**. Most recently, Roche (2003) and McQuinn (2004) argued that previous studies ignored the importance of supply factors in determining house prices and, therefore, overestimated the degree of house price overvaluation. In particular, Roche (2003) added two supply variables—*real construction cost* and *land cost*—to a

[3] This approach is equivalent to estimating the reduced-form equation of house prices on income only.

reduced-form equation relating house prices to fundamentals.[4] In this case, the degree of overvaluation in 2002 was in the range of 0-4½ percent, leading the author to the conclusion Irish house prices were in line with fundamentals. Using the same supply-side variables, McQuinn (2004) also concluded that the surge in house prices could be fully explained by fundamentals, but noted an important caveat to his results— the potential endogeneity of land prices.

13. **However, the supply variable that is most important in explaining the Irish house price boom is also most likely to suffer from endogeneity problems.** As highlighted in Roche (2003), "*trends in land costs are the most important factor explaining the trend in new house prices.*" But, as the first Bacon report (1998) points out, "*...A key issue is the direction of causation between land cost and house prices. In other words, is it the supply and demand for housing that is pushing development land prices or higher land prices that are pushing housing costs? From an economic point of view the balance of probability would suggest the former channel rather than the latter....*" If land prices are indeed endogenous to the real estate cycle but included as an explanatory variable in the house price equation, the overall importance of fundamentals in explaining the surge in house prices could be substantially overstated.

14. **Projections based on a simple econometric model suggest that house price increases should moderate going forward.** We estimated a simple reduced-form equation of log real house prices as a function of demand-side factors (log disposable income per capita, real mortgage rates and net migration).[5] As expected, the income elasticity of house prices (1.17) was strongly significant and consistent with results from the literature. Similarly the coefficients of real mortgage rates (-0.02) and net migration (0.001) had the expected signs and were significant.[6] The estimation results indicated that if disposable income per capita were to increase by 4.5 percent, real mortgage rates were at 1.7 percent and net migration were the same as in 2003, real house price inflation should be around 5 percent by end 2004.[7]

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[4] The demand-side variables used in his model are the number of new migrants, the user cost of housing, real disposable income, and real household credit.

[5] House prices are a weighted average of new and second-hand house prices. The weights use are the ratio of loans paid on new and other houses total loans.

[6] An alternative specification including supply factors was also estimated but many coefficients were insignificant and had the wrong signs.

[7] Our assumption of real mortgage rates is based on short-term euro rates of 2.3 percent and inflation in line with euro rates.

15. **However, one big drawback to interpreting these results is the inherently backward-looking nature of the econometric approach.** In relying on historical data to estimate the model coefficients, one ignores the possibility that the relationship between house prices and fundamentals may be different in the future. Given the likely structural changes in the economy (associated with Ireland's transition from the boom years of the 1990s to a period of slower income growth), this possibility is distinct and should not be ignored. Therefore, we turn to a more forward-looking approach to housing valuation.

House prices, rents, and the price-to-earnings (P/E) ratio

16. **An alternative valuation method considers house prices in an asset-pricing framework.** In this setup, housing can be treated as an asset that provides a flow of housing services. As such, its price should reflect its future income stream. Applying an asset-pricing framework similar to the dividend-discount model for equity valuation, the price of a house should be the present value of its expected benefit of ownership: rental income (market or imputed), discounted at a rate that accounts for the risk associated with holding the asset.[8] In other words, the house price, P_t , is related to the rent E_t and the (constant) discount rate R as follows:

$$P_t = \frac{E_t}{(1+R)} + \frac{E_{t+1}}{(1+R)^2} + \frac{E_{t+2}}{(1+R)^3} + \ldots = \sum_{j=1}^{\infty} \frac{E_{t+j-1}}{(1+R)^j}$$

Assuming that rents grow at a constant rate, *g*, the housing price-to-earnings ratio can be derived from the above expression:

$$\frac{P_t}{E_t} = \frac{1}{R-g} = \frac{1}{r^f + \delta - g}$$

where r^f is the real riskless rate and δ is the housing risk premium.

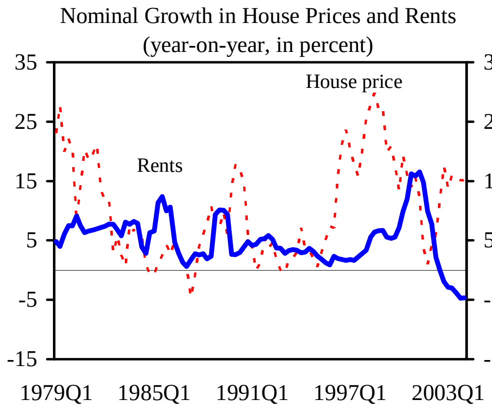
17. **The latter asset-pricing equation demonstrates the link between house prices and rents.** Several observations are of interest:

- The housing P/E ratio provides a useful way to examine whether housing prices are overvalued, since the ratio is invariant to the extent that supply and demand factors influence both the rental and owner-occupier markets.

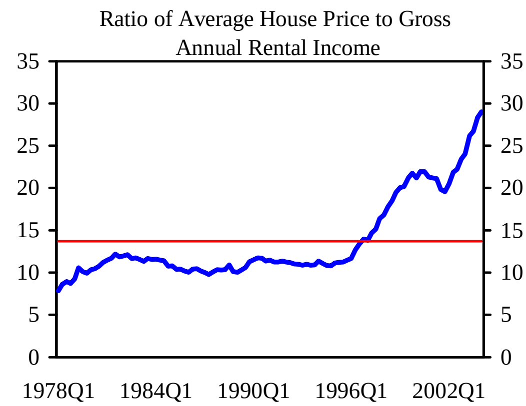
- A decline in the real interest rate, r^f, (or the housing risk premium, δ), or an increase in the growth rate of rents, *g*, could justify a hike in the P/E ratio.

[8] See Weeken (2004), Leamer (2002), Krainer (2003), and Ayuso and Restoy (2003).

- But an increasing P/E ratio could also signal that people are purchasing houses in expectation of capital appreciation rather than due to fundamentals. In this case, house prices would rise faster than rents, prompting a rise in the P/E ratio.



Sources: CSO; Department of Environment.



Sources: CSO; Department of Environment; 2003 Quarterly National Household Survey; and staff calculations.

18. **Currently, the P/E ratio in Ireland is over 100 percent above its historical average** (see chart above). A proxy for the ratio has been constructed by dividing the average house price by the annual rent paid in the private rental market.[9] Interestingly, the sharp rise over the past two years has reflected the significant pickup in house price growth *and* the continued slowdown in rental income growth. In the first quarter of 2004, the P/E ratio is estimated at 29.

19. **What can explain the recent rise in the P/E ratio?** One potential explanation is that a decline in the real riskless interest rate, r^f, (and, hence, the discount rate), has driven up the P/E ratio. However, real interest rates have remained broadly stable since 2000, that is, their fall preceded the rise in the ratio by almost two years. Another potential explanation is that the growth rate of rental income, *g*, has gone up. But actual developments point to the opposite finding—growth in rental income has fallen and been negative in every quarter since mid-2002. If one cannot find convincing, fundamentals-driven reasons for the dramatic rise in the housing P/E ratio, then two possible explanations remain: either the new and second-

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[9] The house price is the weighted average of new and second hand house prices. The annual gross rent is derived using the Central Statistical Office index of private rents and the monthly rental rate in the third quarter of 2003 available from the housing module of the 2003 Quarterly National Housing Survey. Strictly speaking, one should use net (rather than gross) rental income (which excludes operating costs, such as those on maintenance and property management) and only the part of net rental income that is not spent on new housing investment, i.e., the housing dividend. Because data limitations prevent us from constructing these series, we use gross rental income instead.

hand housing market owes its recent strength to the expectation of capital appreciation, *or* the P/E valuation model suffers from serious problems.

20. **As usual, this analysis is subject to a number of important limitations and caveats.**[10] *First*, the role of leverage is not considered. As residential property is typically financed by mortgage borrowing, the return (or loss) on the initial housing investment is magnified. The impact of this factor on investor demand is not considered in the P/E analysis. *Second*, the tax treatment and regulation of owner-occupied and rental housing are not incorporated in the model. A more favorable tax treatment of housing relative to other asset classes could justify a high P/E ratio. *Third*, the model implicitly assumes that people are indifferent between owning and renting a house. A violation of this assumption would produce a wedge between rents and the flow of housing services. *Fourth*, the lumpiness of housing may imply a limited diversification across other asset classes and properties, possibly leading to a higher risk premium. *Fifth*, existing data limitations (related to the coverage, quality, and availability of house price and rental series) make it difficult to draw definitive conclusions.

21. **Nonetheless, the asset valuation approach still provides a helpful reference point to evaluate future changes in house prices.** The main implication of the asset-pricing approach is that the current level of house prices should incorporate not only the current values of fundamentals, but also expectations about their future values. Therefore, only *changes* in trends of fundamentals matter for *changes* in house price trends. In the absence of such changes, house prices are expected to grow in line with the growth rate of rental income, g. Assuming that over the medium run, g, does not exceed the growth rate of economywide income, future real house price increases in Ireland should not be higher than 4–5 percent, reflecting the lower medium-term prospects for real income growth.

D. Descriptive Evidence

22. **Several pieces of additional evidence can also help understand the recent dynamics of Ireland's house prices.** In particular, developments in the buy-to-let and second-home markets and the market response to policy changes provide suggestive information about the role of fundamental and speculative factors in explaining the house price increases over the past few years. Also, evidence from various surveys sheds more light on the motivation and expectations of home-buyers. Together, these sources of information give some indication of whether house price expectations have adjusted to the new environment of lower growth.

[10] See Weeken (2004) for a more detailed discussion.

Developments in the buy-to-let and second-home markets

23. **The buy-to-let market has been very active in recent years, although the stock of private rental housing is still comparatively low.** According to the latest Quarterly National Household Survey, private rental dwellings make up about 8 percent of the total number of residential dwellings. However, survey data collected from banks and real estate agencies point to a high level of activity in this market segment:

- On the demand side, new "buy-to-let" mortgages constituted about 20 percent of all mortgage transactions in 2003 (Standard and Poor's). Investors bought about 28 percent of all new properties and 21 percent of all second hand properties in 2003, compared with 25 percent and 17 percent, respectively, in 2002 (Sherry FitzGerald, 2003).[11] In Dublin, investors accounted for approximately 25 percent of all purchases in the new-house market in 2003, compared with 15 percent in the second hand market (EBS/Gunne, 2004).

- On the supply side, an estimated 30 percent of the second-hand dwellings sold during the first half of this year were previously held as investment properties, compared with about 27 percent in 2003 (Sherry FitzGerald, 2003).

24. **Who has invested in the buy-to-let market and why**? Recent surveys of residential investment property owners suggest that the market is dominated by small, mostly inexperienced investors, whose primary investment objective is to provide for retirement.

- The *Gunne January 2003 Annual Landlord Survey* reports that about 60 percent of investors have been in the buy-to-let market for three years or less (see figure below). The survey also finds that 52 percent of the respondents have invested in the market following the reintroduction of mortgage relief for rental properties (see para 28 below).

- The same survey shows that over 50 percent of the landlords have only one property.

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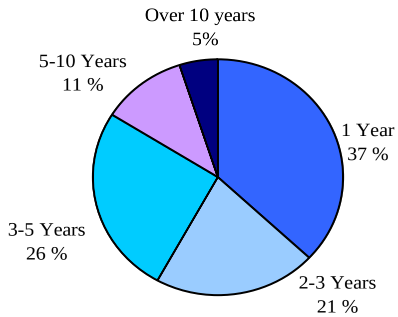
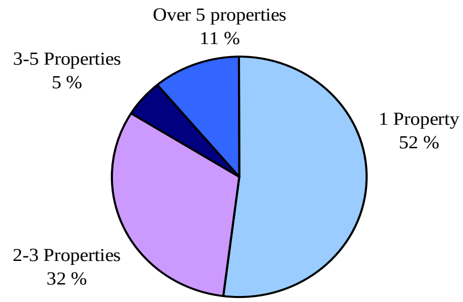
[11] Preliminary estimates indicate that investors purchased 21 percent of the secondhand houses traded during the first six months of 2004, compared with 19 percent during the same period in 2003.

Classification of investors by date of entry in the market



Classification of landlords by number of properties



Source: Gunne Research Group.

- The *EBS/Gunne March 2004 Report* indicates that over 75 percent of the residential property investors have specified pension saving (for themselves or their partners) as their main investment objective.

25. **Even if small in size, the buy-to-let sector could have a significant impact on the dynamics of house prices**. With property investors taking an active part in the housing market, the question is to what extent they have exerted upward pressure on house prices. Lured by the substantial capital appreciation and supported by the small carrying costs observed in the recent past, many new investors have entered the buy-to-let market, possibly displacing first-time buyers and contributing significantly to housing demand and house prices. By itself, this development is not necessarily worrisome, unless there is evidence that the recent wave of property investment has been driven by unrealistic expectations about future house price increases. Unfortunately, the robust demand for rental property investment in 2003—in spite of a continued decline in private rents—suggests that new, inexperienced investors may have entered the market with such expectations, thereby fuelling the demand for housing.

26. **Demand for second homes appears to be an important factor in the housing market as well.** This market segment consists of households that purchase residential property as a holiday or retirement home or as a (vacant) investment property, which is not used for rental purposes. It is difficult to assess the size of the second-home market, separating it from the buy-to-let market.[12] Nevertheless, Davy Stockbrokers (2003) estimate that about 40 percent of houses in 2003 were *not* bought as a primary residence, but rather as

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[12] In Australia, the 2002 Household, Income, and Labour Dynamics Survey provides a breakdown of these categories, as well as comprehensive data on the characteristics of property investors (see the 2004 *Reserve Bank of Australia Bulletin*). To our knowledge, there is no representative household survey in Ireland that contains the same type of information.

a second-home (or buy-to-let) property. Combining this estimate with data from the buy-to-let market (see para. 23), one could approximate second-home purchases to have been up to 15 to 20 percent of the residential property acquisitions in 2003. In other words, although housing supply has risen tremendously in recent years (see para 7), a surprisingly large proportion of it appears to be satisfying demand for second-home properties. As in the case of the buy-to-let market, some of the properties may have been acquired with the expectation that house prices would continue to grow at their current pace in the future.

Response of the housing market to policy measures

27. **Identified as a significant cause for concern, the buoyancy of house prices prompted the government to introduce a package of tax measures in 1998 to slow the market.**[13] Following the publication of the first Bacon report, which warned that strong investor demand was causing the housing market to overheat and pricing first-time buyers out of the market, the government announced in April 1998 a set of policy measures to dampen investor demand and increase the potential supply of housing:[14]

- *Tax relief on mortgages for residential investment*. The deductibility of mortgage interest for investment in residential property (against rental income) was removed.
- *Stamp duty*. The zero stamp duty on purchases of new houses was eliminated for nonowner occupiers only. At the same time, the stamp duty for second hand houses was lowered across the board.
- *Section 23 relief*. The tax relief under Section 23 for investment in private rental accommodation was restricted.
- *Capital gains tax*. The capital gains tax rate on disposals of qualified residential land was reduced temporarily from 40 percent to 20 percent.[15]

28. **However, the tax measures affecting property investors were reversed in Budget 2002.** *First,* mortgage interest relief for investors was reintroduced starting in January 1,

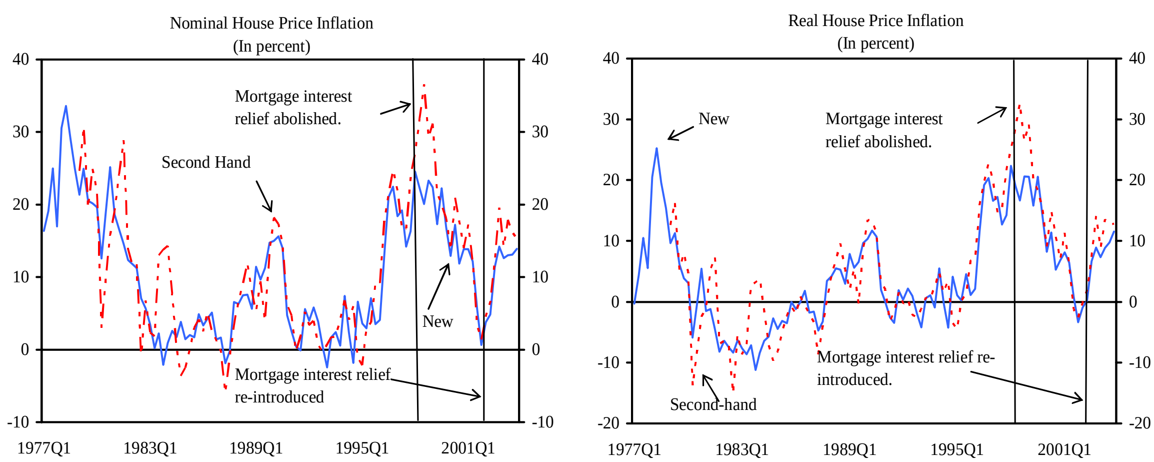
[13] In June 2000, the government also announced the introduction of an anti-speculation tax of 2 percent on the value of all newly-acquired residential investment properties for a period of three years, with exemptions for qualified rented properties. However, the tax was removed in 2001.

[14] The full set of measures is outlined in the document *Action on House Prices*, published by the Department of the Environment, Heritage and Local Government in 1998.

[15] However, the capital gains tax on disposals of *all* development land was reduced to 20 percent on December 1, 1999.

2002. *Second*, stamp duty levels on new property for investors were lowered and brought into alignment with those on second hand property for non-first-time owner-occupiers.

29. **Did the measures of 1998 and 2002 have an impact on house prices?** The observed correlation between the tax changes and the pattern of house price increases is remarkably strong (see chart), raising the question whether the policy changes influenced the dynamics of house prices. Although mortgage rates were in a steady decline during the whole period, growth in house prices decelerated sharply between 1998 and early 2002 but rebounded in mid-2002. Changes in disposable income and demographics appear unlikely to help explain the slowdown and pickup in house prices during the period.



Sources: OECD, The Department of Environment, Heritage and Local Government, and staff calculations.

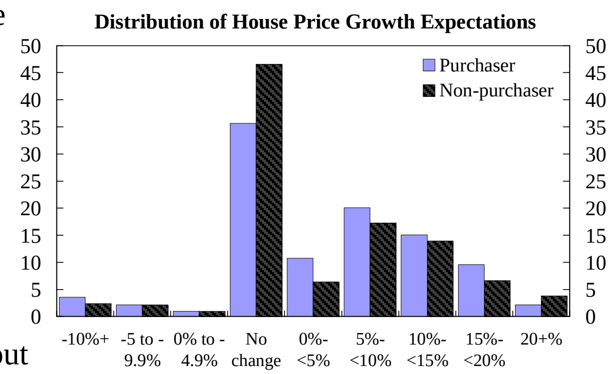
30. **The policy measures could have influenced the recent dynamics of house prices in several ways**. One possibility, supported by anecdotal evidence and market commentary, is that the tax changes had a direct effect on the market by pushing investors out of the market in 1998 and inviting them back in 2002. Unfortunately, the lack of representative time-series data on the residential property investment market makes it difficult to reach firm conclusions on the magnitude of this effect. In addition, the policy measures could have had an impact on house price expectations.[16] While hard to verify empirically, the premise that policy actions can play a significant role in adjusting house price expectations appears to be perfectly plausible.

[16] The importance of this effect was highlighted in Finance Minister McCreevy's speech announcing the 1998 measures, which stated that "*…the package of measures announced last Thursday will help restore balance to the housing market. It will also help to remove another significant factor that has been fuelling price escalation, namely the expectation or—depending on one's perspective—fear of further major price increases. The very publication of the [Bacon] report itself together with the Government's speedy response will help take much of the hype out of the market. It is not without significance that as the publication of the report was approaching there were increasingly frequent comments to the effect that the market 'is about to right itself and that prices are set to stabilise soon.*"

Expectations about the housing market

31. **The distinguishing characteristics of a booming market have been analyzed carefully in the recent housing literature.** Using survey evidence from U.S. cities, Case and Shiller (2003) have examined the homebuyer behavior in a boom property market, highlighting some of its interesting features. *First*, the vast majority of people in such a market expect significant future price increases—an average of 10 percent per year over the next few years, but about 15 percent per year over the next ten years. *Second*, a large proportion of the respondents view the purchase of a house as an investment. *Third*, people feel a sense of urgency in buying a house (over 70 percent of the respondents noted that it was a good time to purchase a property because house prices would increase in the future).

32. **Although direct evidence on the motivation and expectations of homebuyers in Ireland is scarce, two recent surveys do provide interesting, but somewhat mixed, information.** Conducted in August 2003, the IIB/ESRI survey *Irish Consumer Sentiment towards the Property Market* found that, on average, respondents expected house prices to rise by 4.8 percent over the next 12 months. However, the distribution of price expectations was quite wide, with about 25 percent of the people projecting increases of over 10 percent. (Unfortunately, the survey did not ask the more important question about longer-term price expectations.) The second survey containing useful information is the already-mentioned EBS/Gunne survey of residential investment property owners (see Para. 24). Although there was no explicit question about house price expectations, the respondents were asked their views on investing in property and buying intentions. Interestingly, over 90 percent of the residential investment property owners considered housing a preferred choice of investment vehicle, and about 70 percent of them said that they were planning to increase their residential portfolio over the next five years. Noting the softening of the rental market, the EBS/Gunne survey concluded that investor demand would remain strong in the future, as most investors were being attracted to the market by the expectations of future capital appreciation, as opposed to rental growth prospects.[17]



Source: IIB/ESRI

[17] Approximately 30 percent of the respondents said that rental income was insufficient to cover expenses.

E. Concluding Remarks

33. **The bulk of the evidence presented in this paper on the recent house price increases suggests that the housing market has not yet adjusted to the post-Celtic tiger era of lower growth.** Although an important factor, developments in fundamentals appear unlikely to justify the full extent of these increases. The qualitative evidence from Section D implies that at least part of the dynamics of house prices is being driven by the unrealistically high expectations about future price increases of some market participants. With the housing P/E ratio significantly above its long-term trend, it is worrisome that the residential investment market continues to be buoyant.

34. **Going forward, house price increases need to moderate.** As suggested by the asset valuation of housing, future growth in real house prices should be in line with the medium-term prospects for real income growth of 4-5 percent per annum. If house price increases—currently still running in double digits—fail to moderate to these more sustainable rates, the likelihood of a disorderly correction will rise further.

35. **What would be the impact on the economy if the housing market did experience an adjustment?** This remains an open (but clearly important) question, whose answer depends on the linkages between the housing market and the rest of the economy, and consequently, the answers to the following questions:

- *What would be the response of the financial sector?* With 50 percent of the banks' loan portfolio concentrated in the property sector, a sharp correction in house prices could lead to cutbacks in lending as the collateral values and banks profitability decline. This, in turn, could result in a protracted period of slow private consumption and investment.

- *What would be the response of the construction sector?* Accounting for over 10 percent of total employment and over 7 percent of GDP, the construction sector in Ireland could suffer sizable output and employment losses as a direct response to an adverse shock from the housing market.

- *What would be the response of private consumption?* An adjustment in the housing market could affect household consumption in a number of (direct and indirect) ways. Potential employment losses could lead to a protracted slowdown in consumption growth. In principle, consumption growth could also decelerate as a result of the negative wealth and liquidity effects associated with the adjustment in the housing market, although the strength of these channels in Ireland is not well established.

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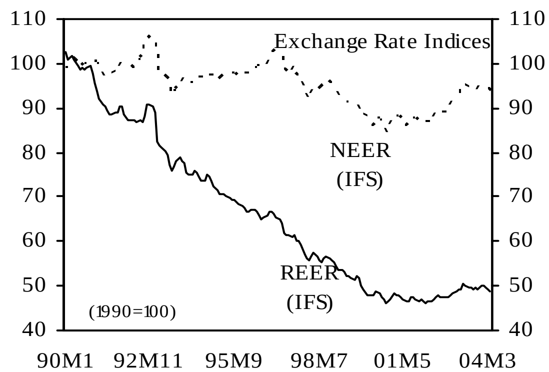
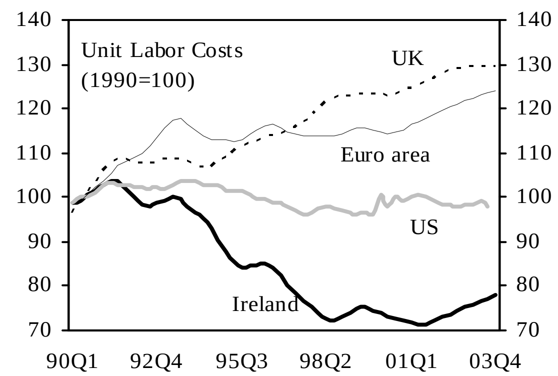
III. The Competitiveness of Irish Manufacturing: An Update[1]

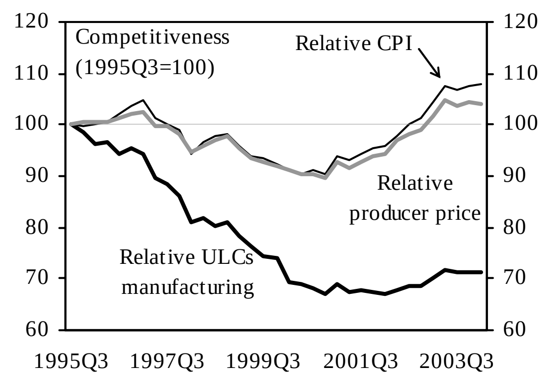
A. Introduction

1. **The manufacturing sector in Ireland has experienced significant gains in competitiveness since the 1990s.** The real effective exchange rate (REER) based on normalized unit labor costs (ULCs) of manufacturing, a measure widely used for assessing external competitiveness, indicates a sharp trend depreciation in the 1990s.[2] The remarkable gains in competitiveness reflected primarily a sustained decline in Irish ULCs of





manufacturing relative to trading partners, which in turn was made possible by impressive productivity growth despite higher inflation in Ireland. Since 2001, strong increases in hourly wages in Ireland and production cuts in the midst of the global slowdown have sharply increased Irish ULCs, thereby arresting the strong trend depreciation. Nevertheless, given the past gains, this measure suggests that the Irish manufacturing sector remains strongly competitive overall.



2. **Alternative measures, however, depict a substantial erosion in Irish competitiveness since 2001.** The real exchange rate based on consumer prices, broadly used to compare the cost of living across countries, has increased by nearly 20 percent since end-2000. Persistently higher inflation in Ireland than in partner countries raised Ireland's price level above those

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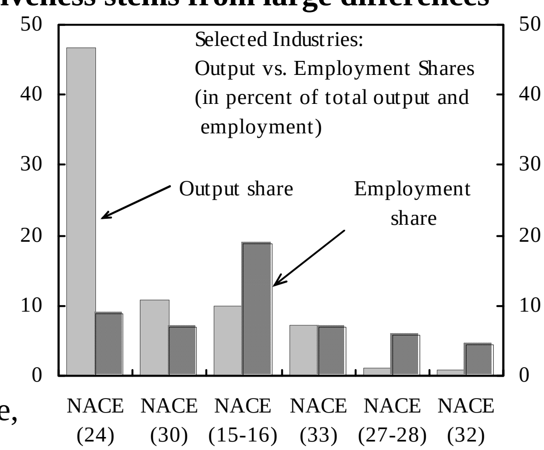
[1] Prepared by Keiko Honjo.

[2] An increase (decline) in the real and nominal effective exchange rates denotes an appreciation (depreciation) or loss (gain) in competitiveness. The ULCs are normalized in the sense that productivity data are smoothed (filtered) to take out cyclical components.

of the partner countries and caused the sharp deterioration. More recently, the substantial strengthening of the euro fueled the appreciation of the nominal effective exchange rate (NEER), which previously had been relatively stable since the mid-1990s, and exacerbated the deterioration. A measure based on relative production costs shows a similar reversal trend, albeit to a lesser extent. Focusing on price and wage competitiveness in Ireland, Lane (2004) finds that the GDP deflator-weighted real exchange rate also points to significant losses in competitiveness since 2001. Cerra and Soikkeli (2002) focus on the dispersion in the competitive position across industries and show that the employment-weighted REER deteriorated significantly in 2001. Following the methodology in Cerra and Soikkeli, this note updates the recent developments in Irish competitiveness in the manufacturing sector. It shows that the erosion in competitiveness experienced in 2001 has continued further, with potentially important employment consequences going forward.

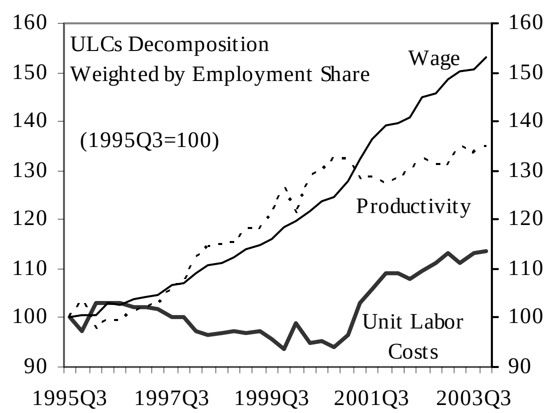
B. Employment-weighted Real Effective Exchange Rate

3. **The contrasting evolution of Irish competitiveness stems from large differences across the manufacturing industries.** Traditional output-weighted measures of competitiveness in manufacturing in Ireland have been widely criticized because the exceptionally strong performance of a handful of multinational-dominated sectors severely distorts the picture. These sectors' large gains in productivity often resulted from intangible foreign inputs into production, such as returns on past R&D, patents, and advertising campaigns abroad. While accounting for a large share of total manufacturing production, these sectors were highly capital intensive, with strikingly small shares in total manufacturing employment. Among them, the dispersion between the output and the employment shares has been considerable in the chemical and pharmaceutical industries (classified as NACE industry 24) and, to a lesser extent, in office machinery and computers (NACE industry 30).



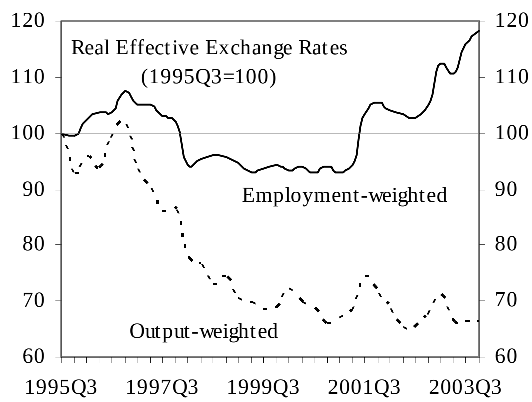
1/ NACE(15-16): food, beverages, and tobacco; NACE(24): chemical and chemical products; NACE(27-28): basic and fabricated metals; NACE(30): office machinery and computers; NACE(32): Radio, TV and communication equipment; and NACE(33): Medical, precision, optical and clock instruments.

4. **The strong wage increases in recent years have had different implications for the ULCs of manufacturing by industries.** More so than capital-intensive industries, which are more immune to the effects of rising wage costs, labor-intensive industries in Ireland have been significantly affected by the recent developments in wages. Weighted by the employment share of manufacturing—rather than the output share—in

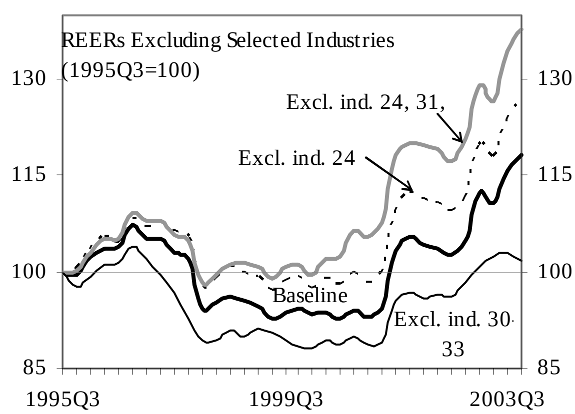


order to capture the sensitivity of the labor-intensive sectors to wages, the ULCs of manufacturing show only a limited decline up to 2001, followed by a sharp increase. Initially, the strong gains in productivity, particularly in chemicals and pharmaceuticals, masked most of the competitiveness losses in the labor-intensive sectors. Since 2001, however, falling production and an acceleration in wage inflation have driven up ULCs.

5. **The movement of the REER weighted by the employment share suggests a significant deterioration in competitiveness since 2001.** Consistent with the developments in employment-weighted ULCs, the employment-weighted REER remained broadly stable during the second half of the 1990s, followed by a notable appreciation since 2001.[3] In contrast, the output-weighted measure shows a steady decline followed by a pause at the depreciated level. The divergence between the two measures has been widening in recent years. The sustained gains in competitiveness shown by the output-based measure were mainly supported by strong production growth in a few industries, which offset the impact of rising ULCs in other industries.



6. **Excluding the capital intensive industries, the deterioration in competitiveness has been more severe.** While the employment-weighted REER is less biased than the output-weighted measures by the strong performance of the handful of capital-intensive multinational industries, the large sectoral dispersion still remains. By excluding these industries, the adjusted REER reflects better the sensitivity of overall Irish manufacturing to wage developments. As expected, without the large cushion provided by the chemicals and pharmaceuticals sectors (NACE 24), competitiveness losses in Ireland would have been even more pronounced since 2001.



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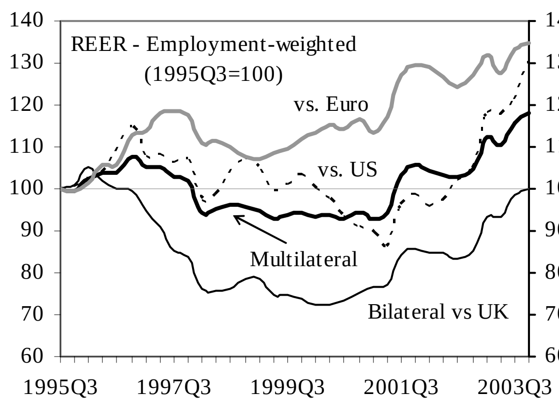
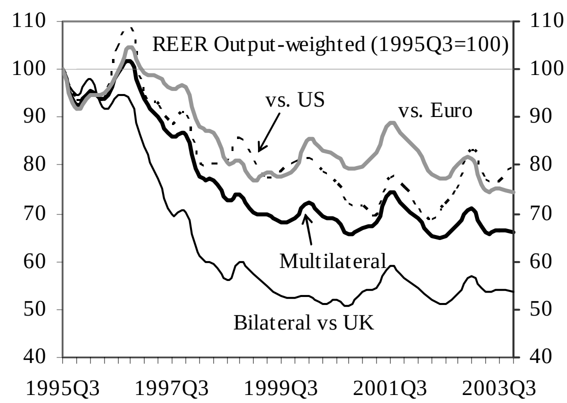
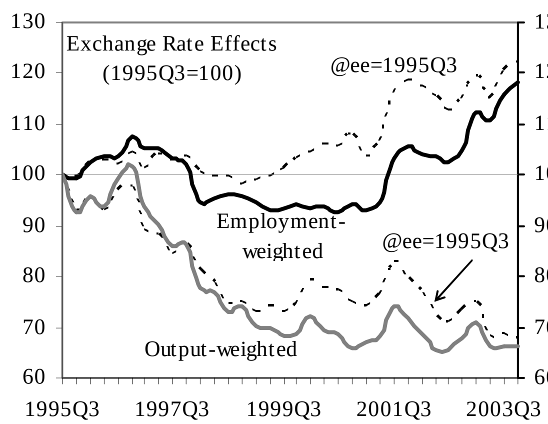
[3] A similar result can be obtained by weighting the REER by total hours worked in manufacturing.

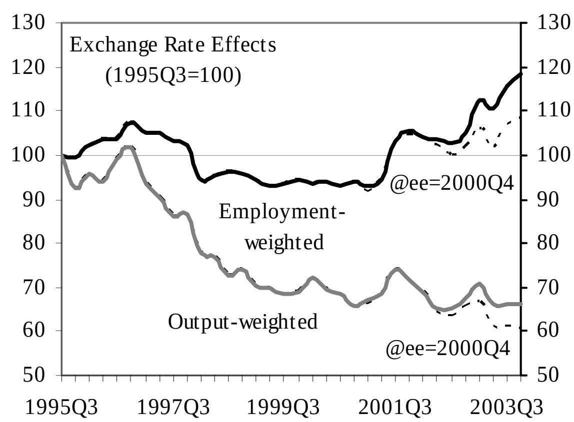
7. **Ireland's competitiveness has varied significantly vis-à-vis partner countries.** On a bilateral basis, and using the employment-weighted measures, Irish manufacturing has maintained large competitiveness gains vis-à-vis the United Kingdom, Ireland's largest trading partner, but the gains have been dwindling rapidly since 2001. In contrast, relative to the euro area, Irish competitiveness has been consistently weak, while Ireland has been becoming less competitive with the United States, a development that is broadly in line with the movement of the multilateral REER. The recent competitiveness losses vis-à-vis the United Kingdom have had significant implications for Ireland's overall external competitiveness, given not only the large share of Irish manufacturing exports to the United Kingdom but also the large volume of consumer goods imported from the United Kingdom. Using the output-weighted measure, however, Ireland has maintained a stable and impressively strong competitiveness position in recent years.





8. **Irish competitiveness is highly sensitive to exchange rate movements.** With Irish membership in the Economic and Monetary Union (EMU), nominal exchange rate fluctuations against the euro area partners have been eliminated. However, currency fluctuations still have a large impact on Irish REER volatility, due to the large proportion of





trade with non-euro countries. The employment-weighted REER evaluated at constant 1995:Q3 exchange rates show that competitiveness was stable until 1998, after which the relative ULCs surged by over 20 percent, partly reflecting a cyclical decline in output. Alternatively, by keeping the exchange rate constant at its end-2000 value, we can explain roughly a half of the competitiveness losses since 2001 through exchange rate developments, which have had a larger impact on employment-weighted measure.

C. Conclusion

9. **Looking ahead, the recent deterioration in Irish competitiveness in manufacturing poses considerable challenges**. Overall Irish economic conditions remain strong, with low unemployment and resilient employment growth. Notwithstanding the swing in the current account balance from surplus to deficits, the deficit remains small, which suggests that Ireland's external competitiveness remains relatively strong. However, the analysis in this note suggests that the main factor supporting Ireland's strong competitiveness has been the high productivity growth in a handful of capital- intensive industries—a development that has masked competitiveness losses in the rest of the labor-intensive sectors. Going forward, with the accession countries gaining strength, Ireland will be facing increasingly stiff competition in attracting FDI inflows. Against this background, controlling wage developments is key to maintaining Irish competitiveness.

10. **A number of caveats should be mentioned.** While this note follows the same methodology and data sources as in Cerra and Soikkeli, the partner country data on production and employment by NACE industry previously obtained by the OECD have recently been discontinued. At the same time, the current exercise maintains the same export weights, which are based on averages over 1998–2000. Notwithstanding these data limitations, the analysis presents a clear picture about the recent trend in Irish competitiveness.

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IV. The role of Social Partnership Agreements in Ireland: Contributing to the boom and facilitating adjustment to sustainable growth[1]

A. Introduction

1. **The social partnership agreements negotiated by the representatives of labor, employers and government since 1987 have often been cited as central to Ireland's economic success.** Although views differ about the precise impact of these agreements, there does appear to be a rather broad consensus that they have contributed importantly to the economic revival that began in the late 1980s. The partnership process was born under conditions of economic crisis that helped coalesce a common view of the macroeconomic conditions required for recovery and instill the willingness in social partners to cooperate to achieve them. The agreements, although principally focused on governing wage growth, have been credited with: generating public support for the policies to foster Ireland's integration within Europe; enhancing Ireland's international competitiveness by moderating wage growth and delivering an era of labor peace; and focusing policy on improving the supply side of the Irish economy. The agreements, however, are not without their critics who have argued that they do not allow for sufficient wage flexibility, may not have delivered the wage restraint that they have been credited with, are becoming too broad and include too many partners, and place inappropriate constraints on public policy.

2. **Understanding the contribution of the social partnership agreements to Ireland's remarkable economic performance over the last decade and a half will be essential to assessing how they may help with the challenges ahead.** In particular, the economic circumstances in Ireland are now much different than in 1987 and the greatest challenge faced by the country will be managing the transition to a lower, more sustainable rate of economic expansion. With a view to stimulating the debate on how social partnership can contribute to this transition, this note outlines the broad nature of the social partnership agreements, their perceived contributions to the Irish miracle, the challenges that the partnership process faces and some suggestions on the directions in which it might be useful to consider modifying the process going forward.

B. Social Partnership Agreements

3. **The social partnership agreements were born at a time of economic crisis that helped to both galvanize a common view of the major sources of Ireland's malaise and build the will to cooperate to remedy them.** Centrally negotiated wage agreements had first been tried in Ireland in the 1970s in response to the stagflation generated by the oil price shocks. However, they were abandoned in 1981 until their revival as part of the first social partnership agreement in 1987. At that time, Ireland faced a severe economic crisis. Growth

[1] Prepared by Ben Hunt.

was nonexistent and unemployment was 17 percent. The fiscal deficit was 8 percent of GDP and the public debt was well over 100 percent of GDP. In response to the deteriorating fiscal situation, tax rates had been soaring thereby reducing real incomes and encouraging net emigration that was draining away Ireland's best and brightest. Ireland was caught in a self-reinforcing downward spiral. Within this context, the social partners were able to agree on a common analysis of Ireland's fundamental macroeconomic problems (*A Strategy for Recovery* (1986)). This common analysis led to agreement on the appropriate redress and the negotiation of the first social partnership agreement.

4. **Initially the agreements focused primarily on the broad macroeconomic environment and income distribution.** In the initial agreement (*Programme for National Recovery*), a moderate pay increase was combined with a commitment to cut fiscal expenditures and reduce labor income taxes to further increase take-home pay. This was viewed as a means to restore growth and allow for improvement in public finances, the key to stabilizing the macroeconomic environment. The next two agreements, the *Programme for Economic and Social Partnership* and the *Programme for Competitiveness and Work* were similarly focused. They combined moderate wage increases with tax reductions that had become feasible with the growing improvement in the fiscal accounts owing to the restoration of growth and prudent management of fiscal expenditures.

5. **As the broad macroeconomic environment stabilized and economic recovery got underway, the focus on supply-side and equity issues increased.** In 1997, the government invited a much wider range of partners than previously to participate in the formulation of *Partnership 2000*. Not only were volunteer organizations invited to participate, but partners' profiles also became more decentralized with representation from the sectoral, community and enterprise levels. See Box 1 for an account of the evolution of the main elements of social partnership agreements.

C. The Contribution of Social Partnership Agreements

6. **The social partners' common analysis of Ireland's economic ills in 1986-87 allowed for a policy environment focused on restoring sound macroeconomic fundamentals**. This common view, shared by social partners and all political parties, is argued to have been instrumental in allowing government policy to shift away from a short-term perspective toward a longer-term strategic focus (Honohan (1999)). In particular, the consensus enabled the government to implement policies to improve public finance as the agreements outlined objectives for the evolution of government debt as a share of GNP. Further, the process sharpened the recognition that Ireland would become increasingly dependant on its integration within the wider European economy, thus building consensus for the macro policies necessary to facilitate that integration. Increasing stability in public finance and macroeconomic performance provided support for Ireland's participation in ERM, setting up a virtuous circle facilitating EMU membership and speeding European integration and the arrival of the associated benefits.

Box 1: The Social Partnership Agreements

Social partnership agreements In Ireland have covered three broad areas: macroeconomic environment; income distribution; and supply-side issues. The first agreement, negotiated between representatives for labor, employers and government, covered a three-year period,1988-90. Since then, a new agreement has been negotiated every three years. The key aspects of each of the agreements are listed below.

Programme for National Recovery (PNR) 1988–1990:

- Basic annual pay increases: 3 percent on the first £120 of weekly pay; 2 percent on any amount above that; and minimum £4 per week increase for the low paid.
- The final pay agreements were to be negotiated at the local level with the expectation that only in exceptional circumstances would the basic increases not be awarded.
- A one hour reduction in the working week to be negotiated locally.
- Commitment by the government to income tax and other tax reforms that would further increase take-home pay and significant cost cutting measure to reduce the budget deficit.

Programme for Economic and Social Progress (PESP) 1991–1993:

- Basic pay increases: 4 percent in the first year; 3 percent in the second year; 3¾ percent in the final year; and minimum per-week increase for the low paid.
- An additional 3 percent local-bargaining component was introduced. It was understood that in negotiations for the additional 3 percent, the implications for competitiveness would be taken into account and there would be allowances for flexibility and change.
- Commitments for job creation in specific sectors and the Minister for Labor committed to undertake specific measures to enhance worker protection, employment equality and holidays.

Programme for Competitiveness and Work (PCW) 1994 – 1996:

- Basic pay increases for the private sector: 2 percent in the first year; 2½ percent in second year; 2½ percent in the first six months of the third year; and 1 percent in the final six months of the third year.
- Basic pay increases in the public sector: a pause for five months; 2 percent in each of the next two years; 1 percent in the next four months, 1½ percent for the next three months; and 1 percent in the last six months.
- Because the public sector had not received the 3 percent local-bargaining component during the term of the PESP, this agreement allowed for those increases to be paid provided allowances were made for flexibility and change and offsetting improvements in quality were achieved.

Partnership 2000, 1997 -1999:

- Basic pay increases: 2½ percent increase for the first year; 2¼ percent for the second year; 1½ percent for the next 9 months; 1 percent in the last 6 months; and minimum pounds-per-week increases for the low paid.
- Local-level negotiations after the first 18 months to augment agreed pay increases by no more than a further 2 percent.
- A reduction in personal income taxes estimated to increase the level of take home pay by 5 percent.
- In addition to pay increases, the agreement covered a range of issues in the following areas: greater social inclusion and equality; promoting enterprise and jobs; modernizing the public sector; and partnership and monitoring.
- The number of social partners invited to participate in the agreement increased with the inclusion of volunteer groups and the extension of partnership to sectoral, community and enterprise levels.

Programme for Prosperity and Fairness (PPF) 2000-2002:

- Basic pay increases: 5½ percent in both the first and second years; 4 percent in the last 9 months; and minimum pounds-per-week increases for the low paid.

- The public sector pay increases were identical with the exception that the final 4 percent increase was to be contingent upon achieving specific performance indicators.

- There was agreement to undertake an exercise to benchmark public sector wages to those in comparable professions in the private sector. This was meant to put a stop to the ever accelerating wage demands resulting from attempt by various public sector unions to restore or maintain historical wage relativities. The recommendations of the benchmarking body were not to be implemented until the next agreement.

- The minimum wage was increased to £4.70 from July 2001 and to £5.00 from October 2002.

- A commitment, through lower labor income taxes, to ensure that net take-home pay including pay increases would increase by at least 25 percent over the period of the agreement.

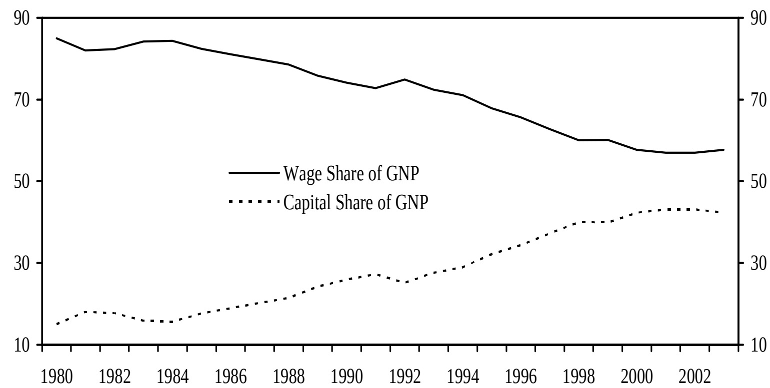
- In addition to pay increases the agreement covered a range of issues in the following areas: living standards and workplace environment; prosperity and economic inclusion; social inclusion and equality; successful adaptation to continuing change; and renewing partnership.

Sustaining Progress (SP) 2003 -2005:

- Basic pay increases for first 18 months: 3 percent in the first 9 months; 2 percent in the next six months; and 2 percent in the final 3 months (first time wage negotiation was split into 2 sub periods).
- Basic pay increases for second 18 months (agreement reached in July 2004): 1.5 percent for last six months of 2004 (2 percent for those with hourly wage of €9.00 or less); 1.5 percent for first six months of 2005; and 2 .5 percent for final six months.
- Increase in minimum wage to €7.00.
- The opt-out provisions for firms unable to pay the agreed increases due to commercial or external competitiveness reasons was strengthened.
- Public sector basic pay increases for first 18 months: pause of six months; 3 percent from January 2004; 2 percent from July 2004; and 2 percent from December 2004.
- Public sector basic pay increases for second 18 months (agreement reached in July 2004): 1.5 percent from June 1 2005; 1.5 percent from December 1, 2005; and 2.5 percent form June 1, 2006.
- It was agreed that 25 percent of the recommendation of the public sector benchmarking body would be effective from January 1, 2001 and would be paid upon ratification of SP. A further 50 percent of the increase would be paid on January 1, 2004 with the final 25 percent paid on June 1, 2005.
- There was agreement that benchmarking would become a regular feature of pay determination in the public sector and the next benchmarking exercise would commence in late 2005 with the report coming in late 2007 (agreed in July 2004).
- In addition to pay increases the agreement covered a range of initiatives in the following areas: special initiatives; building, maintaining and sharing economic development and prosperity; delivering a fair and inclusive society; workplace relations and environment; and delivering quality public services.

7. **The agreements are widely credited with enhancing competitiveness by moderating wage demands, and delivering an era of relatively peaceful labor relations.** Although favorable development in the external environment certainly played an important role in increasing demand for labor in Ireland in the 1990s, the wage moderation contained in the social partnership agreements is argued to have helped maximize the benefits from those developments. It is worth noting that although the agreements only apply explicitly to the unionized sector of the economy (dominated by public sector unions), the agreed wage increases play a critical role in the formulation of wage expectations and thereby provide a benchmark for general wage setting across the whole Irish economy. Lane (1998) illustrates that over the 1987 to 1996 period, the profit share of output, the return on investment and the markup over unit labor costs all increased substantially with a corresponding decline in labor's share of output even in the face of a significant increase in employment. All these point to moderation in wage demands. Figure 1, which presents the labor and capital shares of GNP in the business sector over the 1980 to 2003 period, suggests that the trends identified by Lane continued until the end of the 1990s, after which time shares appear to have stabilized. Additional evidence, presented in Honohan and Walsh (2002), suggests that Irish competitiveness in industry increased steadily over the 1990s, improving by roughly 15 percent relative to its major trading partners by the end of the decade.[2] In terms of labor peace, the evidence suggests that the agreements have had a positive impact. The incidence of strikes and the resulting lost working days presented in Taylor (1996) and extended below in Table 1 suggest that there has been a significant improvement. Relative to the sixteen-year period prior to 1988, the last sixteen-year period has witnessed roughly a fivefold reduction in the average number of days lost per year and a fourfold reduction in the number of disputes. Considering that with employment growth there has been a substantial increase in the potential number of work days since 1987, the improvement is even more significant than the numbers themselves suggest.

Figure 1. Wage and Capital Shares in Business Sector Output



Source: OECD.

Table 1. Number of Disputes and Work Days Lost

During the Sixteen Year Period of 1972-87.			During the Sixteen Year Period of 1988-2003.		
	Disputes	Days Lost		Disputes	Days Lost
1972	131	206,955	**1988**	65	143,393
1973	182	206,725	**1989**	38	50,358
1974	219	551,833	**1990**	49	222,916
1975	151	295,716	**1991**	54	85,513
1976	134	776,949	**1992**	38	190,609
1977	175	442,145	**1993**	47	61,312
1978	152	613,016	**1994**	28	25,550
1979	140	1,464,952	**1995**	34	130,300
1980	130	412,118	**1996**	30	114,585
1981	117	433,979	**1997**	28	74,508
1982	131	434,253	**1998**	33	37,374
1983	154	319,015	**1999**	32	215,587
1984	192	386,421	**2000**	39	97,046
1985	116	417,726	**2001**	24	114,613
1986	102	309,178	**2002**	27	21,257
1987	80	264,339	**2003**	23	37,482
Total	2306	7,535,320	Total	589	1,622,403
Average number of days lost per annum – 470,958			**Average number of days lost per annum – 101,400**		

Source: Central Statistical Office

8. **The agreements have also been credited with improving the supply-side of the economy by facilitating structural change to improve competitiveness.** An important element of the wage negotiation process was the government's commitment to reductions in labor income taxes. In addition to their cited benefit of helping to moderate wage demands, these tax reductions provided a much needed increase in the incentives to work, boosting labor supply. The evidence presented in Taylor (1996) suggests that the local-level component, which was in addition to basic pay increases, successfully increased awareness of the need for flexibility and change and provided the incentives to achieve them, further enhancing productivity and competitiveness.

D. The Challenges To Come

Wage flexibility

9. **Greater nominal wage flexibility will be required in the future because currency union implies a more rigid monetary policy regime than ERM participation.** This argument, as outlined in Calmfors (2003), assumes that under common monetary policy asymmetric shocks or different national responses to common monetary policy will require

[2] In commenting, Barry Bosworth, however, argues that a large part of the increase in Honohan's and Walsh's measure of competitiveness arises from the de-trending technique employed.

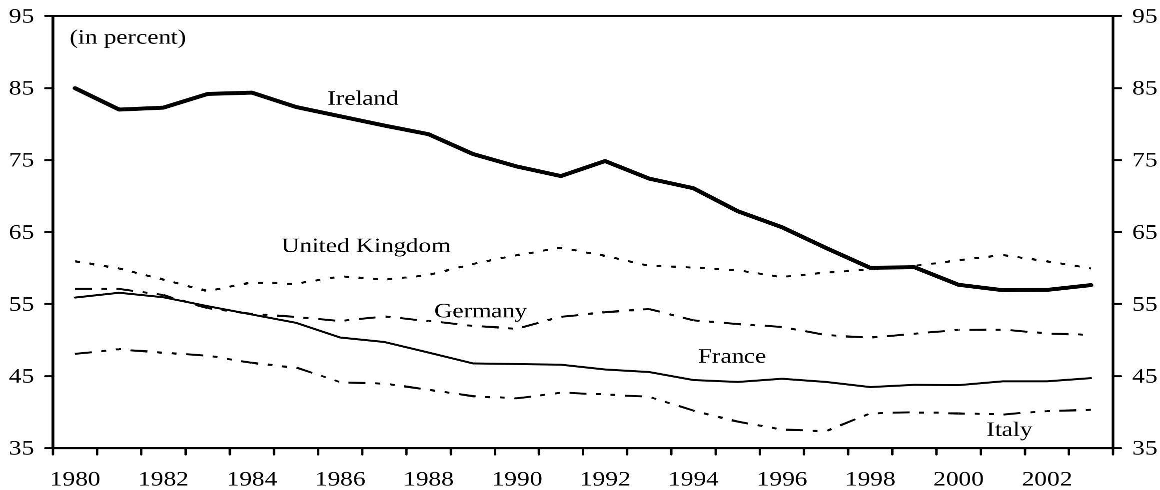
alternative adjustment mechanisms, the most important of which is nominal wage flexibility. Until the most recent agreement (*Sustaining Progress*), the social partners negotiated wage increases to cover three-year periods, which helps to reduce bargaining costs and increases certainty about labor costs for firms. However, nominal wage growth set for three-year intervals may not allow for sufficient flexibility in the face of increased variability in demand and, consequently, employment and output could become more variable.

10. **The success of partnership agreements in improving economic growth in Ireland and bringing living standards up to the European average creates pressure for more flexibility in wage setting.** Figure 2 illustrates that the significant decline in labor's share of output in the business sector in Ireland, which has occurred since the mid 1980s, now brings this ratio close to that in the other major European economies, particularly once payroll taxes, which are not included in the figure, are accounted for. At the same time, Figure 2 illustrates that the decline in labor's share in Ireland did not simply reflect an increase in the capital-to-labor ratio, suggesting that wage moderation via social partnership successfully reduced the relative price of labor. Not surprisingly given Ireland's economic success, the shared sense of crisis and the need for wage moderation no longer appear to have the same prominence in the bargaining process that now appears to be more focused on ensuring real wage gains reflect productivity growth. Accurately forecasting productivity growth over a three-year horizon is difficult and, with the catch-up process largely complete, the tendency to use the past as guide to forecast the future could result in over estimating productivity growth rather than under estimating it as occurred in the past. Wage increases based on a three-year over estimation of productivity growth could seriously erode competitiveness.

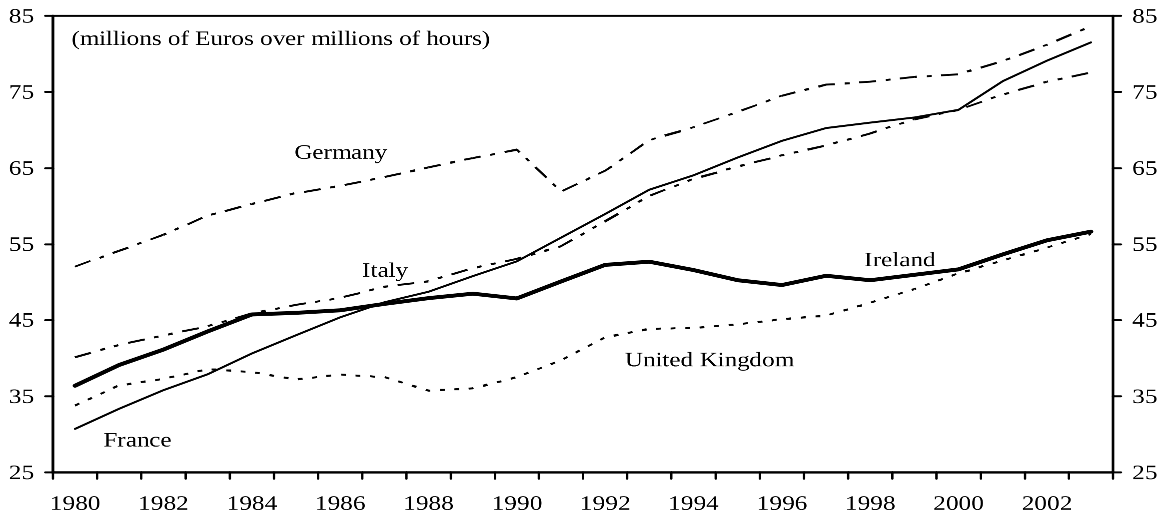
11. **Given that dispersion in productivity growth across sectors is likely to continue to be a feature of the Irish economy, avoiding significant price inflation in low productivity sectors will require increased sectoral wage flexibility.** Ireland's openness and favorable business environment have led to a significant inflow of FDI and a boom in the high technology sector that has become an increasingly important determinant of aggregate productivity growth. Centralized wage increases that are based on aggregate productivity growth with only limited scope for local-level bargaining could lead to wage increases in low productivity sectors that result in significant inflation pressures. If this leads to Irish inflation persistently above that of its major trading partners, competitiveness will be eroded. Partnership faces the daunting challenge of ensuring an equitable sharing of the benefits of real economic growth while at the same time preventing price inflation from eroding competitiveness and undermining future growth prospects.

Figure 2. Cross Country Comparison

Wage Share in Business Sector Output



Capital-Labor Ratio in the Business Sector

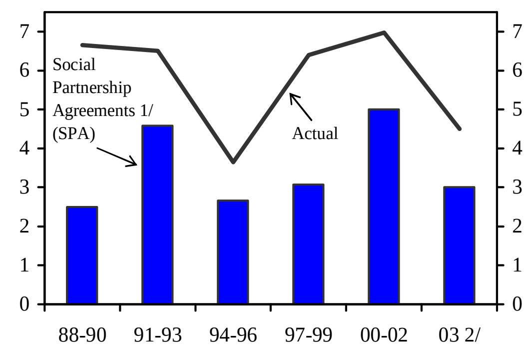


Source OECD

Controlling wage growth

12. **Comparing actual wage growth in Ireland with the increases negotiated through social partnership leads to questions about how tightly the agreements govern wage growth.** Over the period covered by the social partnership agreements, actual wage growth has consistently and significantly outstripped the increases set out in the agreements as the figure illustrates. As noted in MacCoille and McCoy (2001) this has not been due to inflation surprises leading to increases in nominal wages above those negotiated, as real wage increases have also consistently outpaced those envisioned by the agreements. In addition to this casual empiricism, Fitz Gerald (1999), looking for evidence of a structural break in the wage determination process after 1987, finds little empirical support for the theory that social partnership agreements altered the wage determination process in Ireland. It is argued in Boyle, McElligott and O'Leary (2004) that the labor income tax reductions negotiated as part of social partnership may have allowed the public sector wage premium to be maintained when tightness in the labor market, particularly in the late 1990s, might have otherwise eroded it. With private sector disposable incomes benefiting from tax reductions, there may have been less resistance than otherwise to the public sector wage settlements, which, ex post, were also exceeded. In addition, the public sector benchmarking exercise completed in 2003 recommended additional average wage increases of 9 percent above partnership agreed increases that will be completely phased in by mid-2005. In practice it appears that the central wage agreements have set a floor or starting point for local wage determination, even in the public sector. When Ireland was enjoying economic growth that was much faster than anticipated, this did not present a problem. However, it may have ingrained expectations of the wage setting process that will become increasingly impossible to realize as growth moderates to long-term sustainable rates and partnership negotiated basic pay increases are in line with realized inflation and productivity outcomes.

Average of Annual Wage Growth: SPA and Actual



1/ SPA including local-bargaining component.
2/ 2003 data through September.
Source: SPA, MacCoille and McCoy (2001), and Casey (2004).

Broadening social partnership

13. **The growth in both the number of partners and the areas that the agreements cover increases the potential for conflict that could slow and possibly undermine agreement.** Box 2 contains a list of the participants in the most recent agreement, *Sustaining Progress*, and an outline of the areas that the agreement covers. It is argued that broadening the participation and scope of social partnership increases the general ownership of partnership initiatives, increases the commitment to achieve those initiatives and overall contributes positively to formulating the public policy agenda. As noted in O'Donnell (2001), however, this growth also presents a number of challenges. First, for many of the non-pay

Box 2: The Partners Participating and the Coverage of Sustaining Progress 2003-05

Partners: Irish Business and Employers Confederation (IBEC); Irish Congress of Trade Unions (ICTU); Construction Industry Federation (CIF); Irish Farmers' Association (IFA); Irish Creamery Milk Suppliers Association (ICMSA); Irish Co-operative Organization Society Ltd. (ICOS), Marca na Feirme; Irish National Organization of the Unemployed (INOU); Congress Centers for the Unemployed; The Community Platform (consists of 26 organizations); Conference of Religious Ireland (CORI); National Women's' Council of Ireland (MWCI); National Youth Council of Ireland (NYCI); Society of Saint Vincent de Paul; Protestant Aid; Small Firms' Association (SFA); Irish Exporters' Association (IEA); Irish Tourist Industry Confederation (ITIC); and Camber of Commerce of Ireland (CCI).

Coverage:

Part One: A Policy Framework for Sustaining Progress

- **Special Initiatives**: Housing and Accommodation; Cost and Availability of Insurance; Migration and Interculturalism; Long-term Unemployed and Vulnerable Workers and Those Made Redundant; Educational Disadvantage; Waste Management; Care – Children, Disabled and the Elderly; Alcohol and Drug Abuse; Including Everyone in the Information Society; and Ending Child Poverty.

- **Macroeconomic Policy**: Overall Objectives; Public Expenditure; Taxation; and Competitiveness and Inflation.

- **Building Maintaining and Sharing Economic Development and Prosperity:** Overall Objective; Infrastructure and the Environment; and Adaptation to Continuing Change.

- **Delivering a Fair and Inclusive Society:** Poverty and Social Inclusion; Health and Addressing Health Inequalities; Equality; Access to Quality Public Services; and Challenge of Delivering a Fair and Inclusive Society.

Part Two: Pay and the Workplace

- **Private Sector Pay and Related Issues:** Private Sector Pay; Statutory Minimum Pay; Redundancy Payments; Pension and Sick Pay Schemes; Partnership at the Workplace; Affordable Housing Initiative; Anti-Inflation Initiative; and Information, Consultation, Employee Representation and Employer/Employee Dialogue.

- **Workplace Relations and Environment:** Workplace Legislation and Codes; Gender Pay Gap; Work/Life Balance Programmes (Maternity Leave, Adoption Leave, Parental Leave, National framework for Work/Life Balance Polices, Workplace Childcare, Fully Inclusive Social Insurance Model); Equal Opportunities; Workplace Learning; Health and Safety at Work; Hidden Economy Monitoring Group; Pensions; and Migrant Workers.

- **Public Sector Pay and Related Issues:** Public Service Pay; Commitment to Modernization; Modernization and Flexibility; Civil Service; Health Service; Education Sector; Local Government Sector; and Performance Verification.

areas covered in agreements, partners are not bound to take specific actions to ensure their achievement. Consequently, progress has been perceived as slow and each subsequent agreement attempts to strengthen commitments to non-pay initiatives with little evidence of success.[3] Second, as the coverage of issues broadens it includes many more areas that high-level strategies cannot address. As a result, the number of working groups and task forces has areas covered in agreements, partners are not bound to take specific actions to ensure their achievement. Consequently, progress has been perceived as slow and each subsequent agreement attempts to strengthen commitments to non-pay initiatives with little evidence of address. As a result, the number of working groups and task forces has exploded, increasing the bureaucracy surrounding the process. Third, measuring the effectiveness of initiatives in many areas has been difficult and attempts to improve measurement and monitoring of progress are further adding to the bureaucracy. Taken together, these factors suggest that the broadening of the social partnership process, although not without some positive aspects, may slow the process and increase the potential for dissatisfaction and disagreement. This in turn could lead to difficulties in reaching agreement on the central issue of wages. Or, even less desirably, failure to make progress on these only tangentially related issues could lead to pressures and possibly concession on wages that undermine competitiveness.

Constraints on public policy

14. **Although linking tax cuts with wage moderation may have been successful in the past, allowing the social partnership process to dictate and potentially constrain public policy may become problematic going forward.** The reductions in labor income taxes that have been implemented since the beginning of the partnership process were both necessary from a labor supply perspective and warranted because prudent fiscal management during a period of healthy growth dramatically improved public finances setting up a positive self-reinforcing dynamic. Now that the catch-up process in Ireland has moved a long way towards completion, the self-reinforcing dynamic is close to being played out and the scope for further labor income tax cuts is becoming more limited, as are the potential benefits given tax reductions to date and improvements in participation rates. As economic growth in Ireland converges to lower, more sustainable rates, there will be less fiscal room for tax cuts. Further, there will be significant pressure for available resources to be directed toward the improvements in public infrastructure that are required to ensure the sustainability of the current level of economic activity and allow for continued healthy growth. At this point in Ireland's development, public infrastructure investment will likely yield the most substantive gains because the impact of tax cuts on participations rates can be expected (as suggested in

[3] This process is succinctly summarized on page 19 in O'Donnell (2001) "Having got them in, they worked to turn platitudes into agreement. Confronting the limits of that they pressed to turn agreements into commitments. Limited progress suggested it was necessary to turn commitments into targets. Now that the dictionary is used up, the question is how can these targets be met?".

Callan and others (2003)) to yield diminishing marginal returns. The absence of any explicit fiscal concession in the most recent agreement was a welcome sign and the introduction of the multi-year spending envelopes for public investment will likely help to maintain infrastructure investment. However, there are still risks that scarce fiscal resources will not be directed where the returns will be greatest if fiscal policy continues to be linked to wage negotiations.[4] In addition, it can also be argued that public policy should ultimately be determined by the elected legislature not the unelected social partners.

E. The Social Partnership Process Going Forward

15. **Shortening the duration of the wage component of the Social Partnership Agreements would enhance aggregate nominal wage flexibility.** The level of economic uncertainty prevailing when *Sustaining Progress* was being negotiated prompted the social partners to agree to set wage growth initially for only 18 months and then to return to the bargaining table just over a year later to set wage growth for the remaining 18-month period. This clearly served to enhance wage flexibility. Agreed wage growth moderated by 1½ percentage points in the second period. The stricter monetary regime implied by the move from ERM to EMU, the rate of economic expansion slowing to a more sustainable rate, and the fact that wage expectations may not have fully adjusted to actual future growth prospects all ague in favor of continuing to set wage growth for periods shorter than three years. Several commentators have recognized the need for greater flexibility going forward and proposals - such as those in Hardiman (2000), de Buitleir and Thornhill (2001), Macoille and McCoy (2001), and McHale (2001) - have been advanced to increase aggregate flexibility. Essentially the flexibility in these proposal arises from basing part of labor's compensation on ex post outcomes, thereby increasing the responsiveness of wages to realized growth and limiting the potential for forecast errors to erode competitiveness.[5] However, these proposals would be quite difficult to implement in practice and shortening the duration of the wage agreements enhances flexibility while being very straightforward to implement. To reduce, or possibly more than offset, the increased bargaining costs that would arise from more frequent negotiations, social partners could agree on the set of macroeconomic data that would be used regularly to determine the range within which wage settlements should lie prior to the start of negotiations. Although setting wages for shorter intervals would reduce labor cost certainty for firms, this would be offsets by the benefits that would arise from wages being more responsive to unexpected macroeconomic or sector specific developments.

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[4] McHale (2001) notes that in December 2000, key union leaders waited until they saw the contents of the 2001 Budget before giving their final assent to a renegotiation of initial wage increases that had been set out in the PPF.

[5] Part of the drawback of the offered proposals is their complexity, the further entwining of fiscal policy and wage determination (McHale (2001)), and the fact that they do not allow for more sectoral flexibility.

16. **The ability for firms to deviate from agreed wage increases should continue to be strengthened.** Over much of the period covered by social partnership agreements, growth has exceeded expectations and, consequently, partnership agreed wage increases have been affordable to firms. In part this has been at the expense of rapid price inflation in the lower productivity service sector. With Ireland's price level now equal to or above those in its major trading partners, there is no longer any scope for low productivity sectors to accommodate excessive wage increases by raising prices faster than ECB's target rate for inflation. Going forward, a larger number of firms, particularly those in low productivity sectors, may find it difficult to afford partnership agreed wage increase that are based on aggregate inflation and productivity growth. To avoid raising prices, these firms will need to offer wage increases notably below those centrally agreed. It will be important that the mechanism in place to allow firms to do this is not too onerous for firms to resort to and does not lead to labor unrest. Partnership agreements could more explicitly detail exactly what financial or competitive circumstances would allow firms to pay lower than centrally agreed increases. Further, social partners should regularly communicate that it will become increasingly likely that more firms may need to pay less than the centrally agreed increases because the convergence process in Ireland is largely complete.

17. **Fiscal policy concessions should no longer be used to moderate wage demands within the social partnership process.** Although there may have been merit in the past to encouraging wage moderation by having the government commit to labor income tax reductions, circumstances and priorities in Ireland have shifted since the initial days of social partnership. Labor force participation rates suggest that the incentives to work in Ireland are strong, but years of under funding in public infrastructure given the rate of economic expansion has left a public capital stock gap that needs to be filled. If the labor-income-tax option is available, the government could easily be tempted to use it to achieve short-term labor peace if social partnership negotiations are not going well. However, doing so could have very significant medium-term costs if public investment is foregone as a result. This argues for a transparent and binding medium-term fiscal framework that clearly separates fiscal policy from the social partnership wage negotiation process. Government could (and should) continue with its central role in the partnership process both in terms of leadership and as an employer; however, the option for trading wage moderation for tax reductions would be ultimately constrained by the medium-term fiscal framework. Placing constraints on the government's negotiating options in this way would move toward the ideal of having public policy determined by the elected legislature and not the unelected social partners. Further, removing fiscal concessions from the bargaining table could also help speed the negotiation process and offset the increase in costs of holding wage negotiations more frequently than every three years.

18. **Steps should be taken to put more distance between the wage negotiations process and the far reaching social objective that have become an increasingly important part of social partnership agreements.** Broadening the participation in the partnership process has undoubtedly increased the general ownership of partnership initiatives and contributed positively to the formulation of the policy agenda. However, the

large number of participants and issues adds considerably to the time and costs of negotiating each agreement and many of the issues are largely unrelated to the central issue of wages. Having this broader group participate at the time of every other wage negotiation for example would considerably reduce the cost of holding wage negotiations more frequently. This would retain many of the benefits of the current process without a significant loss in its effectiveness as these broader social issues evolve more slowly as policy initiatives require time to have an impact.

F. Conclusions

19. **The social partnership process has made an important contribution to Ireland's exceptional economic revival. However, with circumstances and priorities now much different, changes to the process should be considered.** Strong arguments can be made that the current wage determination process does not provide the nominal wage flexibility that Ireland will need going forward. To increase nominal wage flexibility, shortening the duration of the central wage agreement, as was done for *Sustaining Progress,* should become a permanent feature. Although more frequent wage negotiations could potentially entail increased negotiations costs, steps can be taken on several fronts to minimize these costs. Continuing to strengthening the mechanism for firms to deviate from the centrally agreed increases would also enhance flexibility. In addition, cogent arguments can be made that fiscal policy should be more distant from the wage negotiation process. Developing a medium-term fiscal framework that clearly constrains the government's ability to make fiscal concessions to facilitate agreement would help ensure that scarce public resources are directed where returns will be greatest. The volunteer and community sectors should continue to play an important and helpful role in the partnership process but the cost of this participation should be reduced by having the most inclusive range of partners participate less frequently.

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27/8/08 (68)

SECRET

07/07/2008

Ref. No. S211/2/08

SECRET

Office of the Minister for Finance

Memorandum for the Government

Measures Necessary for Budgetary Consolidation 2008

1. Decision Sought

The Minister for Finance requests the Government:-

(a) to note the sharp deterioration in tax revenues over the first six months of 2008, the revised forecasts for economic growth, the major expenditure pressures arising on the Live Register and other areas, and the associated implications for the public finances in 2008 and 2009;

(b) to agree that the Budget for 2009 to 2011 will be prepared on the basis of ensuring confidence in Ireland both domestically and internationally, through aiming for an overall approach to fiscal policy which will keep the General Government deficit on a path which is consistent with the requirements of the Stability and Growth Pact;

(c) to agree to the immediate implementation of a package of efficiency savings, estimating reductions and other measures to secure savings of €464 million in 2008 on the basis outlined at sections 7 to 9 and set out in Appendix A of this Memorandum, with a combined overall effect of €1 billion in 2009;

(d) to agree immediate action to achieve a reduction in the public service pay bill of 3%, i.e. to yield savings of €190 million in 2009, as set out in section 6;

(e) to agree that the Minister for Finance will conduct a review of all existing capital proposals in the context of securing the necessary expenditure reductions; that no further capital contractual commitments will be entered into in 2008 without the prior sanction of the Minister for Finance;

(f) to agree that no further expenditure on the acquisition of accommodation for decentralisation be sanctioned pending detailed consideration by the Government of the Reports from the Decentralisation Implementation Group and the Implementation Group of Secretaries General;

(g) to agree that each Minister should submit their detailed Estimates of Expenditure to the Minister for Finance by the end of August, taking into account *(i)* his/her own Department's assessment of needs in 2009; *(ii)* the expenditure savings at Appendix A; and *(iii)* such additional savings measures as the Minister in each case may consider appropriate to ensure that expenditure in each case is held to the 2008 levels, having regard to the aggregate expenditure limit set out in section 10;

(h) to agree to the proposals on public procurement and rationalisation of State agencies set out in this Memorandum;

(i) to agree that the net financial position of the local authorities must remain within the previously approved borrowing limit of €200 million, as set out at section 12;

(j) to agree to seek an increase in dividends paid from Commercial State Sponsored Bodies in 2009 to €300 million, broadly 30% of expected profits;

(k) to agree that each Minister must report to Government monthly on progress in achieving the necessary savings in 2008;

(l) to agree to the examination of redundancy / voluntary early retirement proposals as set out in paragraph 5.1 below; and

(m) to agree that the Government will submit a motion on the implementation of the NDP and on the present economic situation as set out in Appendix B.

2. Economic and Budgetary Outlook

The Economy

2.1 On foot of the latest release from the Central Statistics Office showing negative quarterly growth for GDP, the Department of Finance made further revisions to its growth forecast. This was discussed at Cabinet last week and published along with the half yearly Exchequer Returns. The Department is now forecasting growth of around ½% for this year. This revised forecast reflects the changed international conditions and lower domestic activity. Apart from the construction sector, which is depressing growth by up to 4 percentage points, the economy is performing relative well so far. However, it must be noted that downside risks to the short-term outlook remain. Growth of about 2¼% is currently envisaged for 2009 and over the medium-term, if appropriate policies are pursued, trend growth of the order of 4% is likely.

The Public Finances

2.2 The end-June Exchequer Returns were published on 2 July 2008. There was an Exchequer deficit of €5,648 million at end-June compared to a deficit of €1,427 million for the same period in 2007, a deterioration of €4.221 million.

2.3 At end June taxes were €1,450 million or 7% below profile. This was largely due to the weak performance of VAT, CGT and Stamp Duty - together they accounted for 82% of the shortfall. Income tax and Corporation tax have held up close to profile but have slowed and are behind target. A tax shortfall of at least €3 billion is now likely this year.

2.4 Total voted expenditure to end-June 2008 was €205 million or 0.9% (Current €177 million and Capital €28 million) below the published profiles.

2.5 At this stage, assuming that the identified expenditure pressures of the order of €500 million – mainly resulting from increased unemployment – are compensated for by the action proposed in this Memorandum, a General Government deficit of the order 2¾% of GDP has now been publicly signalled. If no action is taken to address the spending pressures then the deficit will be up to the 3% limit. In addition, it is likely that the buyout of the M50 toll bridge, which takes effect in August, at a cost of around €550 million will have to be included in the GGB calculation for 2008. This will worsen the GGB by approximately 0.3% of GDP. It is also assumed that General Government borrowing arising from net borrowing by local authorities will be limited to €200 million as provided for at Budget time. Any slippage would further worsen the General Government Balance (see Section 12)

Table 1: Summary of Economic and Budgetary Emerging Position

	2008	2009
GDP	0.5%	2%–2¼%
General Govt. Balance Deficit (%of GDP)	2¾%-3%	3¾%-4%

3. Requirement for Expenditure Savings in 2008

3.1 As indicated in last month's Expenditure Management Report to the Government, and as publicised at the release of the end-June Exchequer position Returns last week, significant expenditure pressures are emerging in 2008. In particular:-

i) The Live Register has increased from 201,800 at end-May to 220,800 at end-June. The 2008 Budget Estimates were based upon an average Live Register for the year of 170,000: it now appears that a figure of around 210,000 is more realistic – this alone would add some €500 million to expenditure in 2008, borne across the Exchequer and the Social Insurance Fund.

ii) There are also significant spending pressures arising in the Health area (HSE), as well as in some other areas.

3.2 As a result, combined with the tax shortfall of at least €3 billion, **there is now a strong likelihood that we will be in breach <u>in 2008</u> of our EU commitments arising under the Stability and Growth Pact and our membership of the Euro area.** It is imperative that such a situation be avoided and it is essential that immediate and effective action be taken to stem the upward drift and to bring expenditure back into line with the 2008 Budget allocation. The Minister for Finance has indicated publicly that a package of corrective measures will be announced on foot of today's Government decision, to preserve confidence in the sustainability of Ireland's budgetary position.

3.3 Accordingly the Minister for Finance now proposes that the expenditure control initiatives outlined at Appendix A be taken immediately, with a view to securing savings across all Vote Groups of €464 million in 2008, and in turn reducing the 2009 expenditure baseline by €1 billion.

3.4 The principal measures arising in this context include:-

- an immediate payroll cut across the public service (see section 6 below);
- efficiencies in administrative expenditure (see section 7 below);
- a review of non-core capital expenditure as outlined at section 8 below; and
- current policy savings and control savings on Social Welfare (see section 9 below).

4. Pay Bill

4.1 The current public sector pay deal expires on 30 September 2008 with the final round increase of 2.5% payable from 1 September. The pay bill is €19 billion, so each 1% costs €200 million. The Minister cannot see how a further pay increase in 2009 can be afforded.

5. Redundancy / Voluntary Early Retirement

5.1 In addition, the Minister proposes that the Department of Finance and the Department of Health and Children should develop proposals for a targeted redundancy / voluntary early retirement scheme, the terms of which with the shortest possible payback period will be agreed between the two Ministers, to be applied in the Health Service Executive in the current year. The Department of Finance will also examine whether such a scheme should also be applied on a selective basis in other public service agencies where surplus staff can be identified.

6. Payroll Adjustment across Public Service

6.1 The Minister proposes that a 3% reduction[1] in the public service pay bill (€190 million in 2009) should be required for all Departments, Agencies, Local Authorities and other bodies. The Minister expects that to meet this requirement, organisations will have to severely restrict recruitment with immediate effect, whether for replacement or additional staff, contract or permanent.

6.2 The Minister recognises that the full 3% reduction will not be achieved in 2008 and the figures set out in Appendix A include a €10 million saving in 2008 (in addition to the efficiencies in 7.2 below).

[1] The 3% is calculated from the 2008 pay bill allocation adjusted for the full-year effect of the 2008 pay round, and subject to the exceptions set out in para. 6.3. Amounts allocated to each Department / Agency may be subject to minor rounding effects.

6.3 With the exception of staff involved in the delivery of essential front-line health services, the payroll cut will apply equally to the HSE and the health sector generally. Similarly in the Education area, the payroll cut will apply to all staff, with the exception of front-line staff in schools, i.e. teachers and Special Needs Assistants (SNAs). In that regard, a ceiling on the number of additional teaching posts for the 2008/09 school year will have to be agreed with the Department of Finance.

6.4 As regards Local Authorities, the Minister expects that his colleague the Minister for the Environment, Heritage & Local Government will put similar measures in place in this area.

7. Efficiencies in Administrative Expenditure

7.1 Arising from the Efficiency Review exercise which all Departments have conducted together with their agencies, a range of administrative savings have been identified that should now be acted upon. Drawing on the returns made by Departments and on work carried out by his own Department, the Minister for Finance considers that savings in administrative costs can be realised across all Departments and Agencies.

7.2 Savings of around €224 million should be secured under this heading in 2009 (of which €47 million is in respect of Administrative Budgets) and savings of **€50 million should be secured in 2008.** The distribution of these savings is shown in Appendix A.

Discretionary Expenditure on Consultancies, Advertising and Public Relations

7.3 In addition to the general administrative efficiencies, there is significant scope for cutting back on the level of expenditure on consultancies, which amount to €90 million in Voted moneys alone in 2008. Accordingly, Departments and agencies should re-examine and curtail their use of consultants, with a view to reducing expenditure in this area for the remainder of this year and by at least 50% in 2009. This should yield savings of around **€11 million in the remainder of 2008.**

7.4 Moreover, the total level of spending on advertising and public relations is reported by Departments and their Agencies to be of the order of €150 million in 2008. The Minister considers that a similar curtailment of 50% will need to be achieved in this area, which should give rise to savings of around **€10 million in the remainder of 2008.**

Public Procurement

7.5 Public procurement of goods, services and capital works amounts to some €15-17 billion (€8-10 billion on goods and services and €7 billion on works) per annum. Every Department, office and agency will be required to specify reductions in procurement spending in 2009 equivalent to 2 per cent of their 2008 allocation. These savings are to be achieved by (i) postponement or rescheduling of purchases; and (ii) better procurement practice. A minimum cost saving of €50 million should be achieved in 2009.

7.6 The Minister has decided to assign responsibility for the management of public procurement operations to Minister Mansergh and the Office of Public Works. A joint implementation group between Finance and OPW will be set up to drive a programme of reform and develop a business plan for procurement that will assist Departments and other public service bodies in delivering savings. This group will report to the Minister in September 2008 with specific proposals to meet the €50 million target for 2009.

8. Review of Capital projects

8.1 The Minister believes that sustained commitment to capital investment, in line with the NDP, is essential to developing our economic capacity into the medium- and longer-term, as well as providing economic support to construction activity in the near-term. Given the present position of the public finances, however, the Minister considers it necessary to that capital projects that do not have a strong economic rationale, or that are not pre-committed for contractual or legal reasons, should now be reviewed critically by Ministers and consideration should be given to re-profiling them for possible implementation at a later stage of the multi-annual envelope framework. The Minister considers that ***capital resources must be targeted in the first instance at construction-related investment in core economic infrastructure that adds to productive capacity.***

8.2 Based on a preliminary analysis within the Department of Finance, some €16.6 billion out of the total €19.1 billion Exchequer capital investment scheduled for 2009 and 2010 can be classified as either a priority for core economic investment, or as a pre-committed item. There is accordingly a good deal of scope for Ministers to prioritise capital expenditure to contribute to necessary expenditure savings in 2008. The Minister accordingly proposes that ***no new capital contracts should be entered into by Departments*** without his specific sanction, on the basis of a review of all proposed capital contracts over the remainder of 2008.

8.3 As a first step, the Minister for Finance has already identified at Appendix A some areas where he considers that capital savings can be made. For other Departments, no specific savings have been tabled yet. If Departments have re-assessed their own capital programmes and can agree savings / deferments with the Department of Finance, then the necessary sanction can issue without delay. Alternatively, if Departments are not in a position to identify savings, the contracts for capital projects will be submitted to the Minister for Finance for review, to enable him to identify specific savings.

Decentralisation

8.4 As regards decentralisation, the Government decided on 30th January, 2008 (Decision S14422L) to ask the Decentralisation Implementation Group (DIG) to carry out an examination of the feasibility of phased moves by the State

Agencies and to provide a report, including target timescales, to the Minister in advance of the quarterly report to Government in July, 2008. In addition, the Government Decision agreed that the Implementation Group of Secretaries General be asked to deal with the Governmental and cross-Departmental issues and the need to provide facilities for Ministers, Ministers of State and officials while in Dublin on business.

8.5 In the light of the current Exchequer position the Minister would propose to his colleagues that ***no further expenditure on the acquisition of accommodation for decentralisation be sanctioned*** pending detailed consideration by the Government of the Reports from the DIG and the Implementation Group of Secretaries General.

9. Current Policy Savings

9.1 There are a number of areas where current savings are emerging, either because schemes have not started or because they are proceeding at a slower rate than anticipated. The Minister proposes that these savings should now be surrendered. The items involved here include, in the Health area, savings of €85 million on the Fair Deal programme, which will not now commence in 2008; these savings will form part of overall 2008 savings of €144 million which the Minister for Health & Children has agreed to deliver. Other savings include FÁS apprenticeships (€10 million) where the number of participants has fallen and the REACH project in the Department of Finance (€2.5 million). In addition, the ODA was €67 million behind profile at the end of June and while some of this will be spent in the second half of the year, it is now expected that the end year position will be around €45 million behind.

9.2 In the area of social welfare, the Minister is aware that the very significant increase in demand brings with it increased need to ensure that resources are only provided to those in need and who have an entitlement to them. It is important to monitor and adjust control strategies to meet evolving scheme activity and risk factors. The Minister has written to his colleague the Minister for Social and Family Affairs and asked her to introduce more effective control mechanisms in the light of growing unemployment and uncertain migration flows in and out of the State. The Minister has accordingly included a saving of €50 million this year on the Social and Family Affairs vote.

9.3 The Minister is concerned about the huge and ongoing costs of the various tribunals. He is particularly concerned that the duration of the tribunals means that the costs will be ongoing for some time to come. He considers that the Government should take steps, in consultation with the Chairmen of the tribunals, to bring the tribunals to an end at an early date. The Minister is also considering whether he can take steps to mitigate the legal costs, including third party costs. The Minister will be bringing a separate Memorandum to Government on this issue today to end the operation of tribunals within a short timeframe.

10. Proposals for Securing Expenditure Savings in 2009

10.1 As made clear in the recent Budgetary Strategy Memorandum, the overall fiscal position has deteriorated significantly since the *Programme for Government*, the *National Development Plan 2007-2013* and the *Towards 2016* agreement were finalised. All of these documents included a clear proviso that the delivery of programmes was subject to availability of resources. Now that resources have fallen away to such an extent, it is necessary to forgo the introduction of many planned new spending programmes, and indeed to scale back on some existing programmes, if room is to be made for even a modest social welfare package in the 2009 Budget.

10.2 The consequential savings arising from the stringent measures outlined above will reduce the ELS expenditure position for next year by around €1 billion. The means that ***a further €1 billion needs to be cut*** from the Current spending bill through policy changes. The indicative total Current spend for 2009 is now €53 billion and Departments are being asked to prepare Estimates on the basis of this figure. This represents a reduction of 3.4% on the Department of Finance's ELS figure, which itself may be less than Departments' own estimates of their needs. Bearing in mind the difficulties in making adjustments in areas such as Health and Social Welfare, other areas will have to make all the more significant policy changes to meet the overall reduction.

10.3 **The Minister acknowledges that measures to meet these targets will involve sacrifice across all areas. <u>The exigencies of the public finances necessitate such measures.</u>** Apart from the national imperative of taking corrective action, there can be no question of this country reneging on our EU commitments arising under the Stability and Growth Pact and membership of the Euro area.

10.4 The Minister is aware that some Departments may have pressures within their ELS allocations, or difficulties meeting the efficiency requirements. In such cases, the policy adjustments will have to be such as to ensure that the overall €53 billion limit is met. Broadly this means that current expenditure has to be maintained at the 2008 level. Officials from the Minister's Department will be available to meet with their counterparts in other Departments over the next two months or so for relevant discussions.

11. Rationalisation of Agencies, Boards and Other Public Bodies

11.1 The number of staff employed by Non-Commercial Agencies (NCAs) has grown by <u>63%</u> since 2000, compared to 46% in Health, 35% in Education, 27% in Local Authorities and <u>32%</u> overall in the public sector since 2000. The number of such bodies has increased from approximately 140 to 230, with an associated increase in public-sector numbers employed in these agencies from approximately 9,800 to over 16,000 at present. Annual expenditure by the NCAs has risen from €3.7 billion in 2003 to €6.1 billion in 2008, based on the returns from Departments printed in the annual REV.

11.2 One of the effects of the proliferation of agencies and bodies is the difficulty which citizens have in knowing how to access either information or services. We need to make the system of government more citizen-friendly. Therefore, the time is ripe to take a determined approach to reducing the number of Boards and Agencies, with a view to securing major savings in administrative overheads including staff numbers, and a better, more focused delivery of services. The Minister believes these bodies should be rationalised / amalgamated as a priority and requests the Government to direct that this be done.

11.3 The Minister will accordingly instruct his officials to engage in discussions with each Department with a view to securing further rationalisation in NCAs and thereby identifying further administrative savings for 2009 and subsequent years. The scope for bringing Agencies more fully within the control of Departments, to ensure appropriate accountability and cost-control, will also be pursued in this context. The Minister will report back to Government on progress in respect of these proposals by the end of September. Savings under this initiative will accrue over time, but by September a firm estimate should be available of what can be achieved in 2009. The initial ***indicative 2009 saving of €20 million*** is the absolute minimum that must be achieved.

12. Local Government Expenditure and the GGB Constraints

12.1 Local authorities are part of the General Government sector and their activities impact upon the General Government Balance (GGB). Their net financial position must therefore be considered in the context of overall budgetary policy. In 2007, local authorities' net position swung from a €400 million surplus to a €265 million deficit impacting on the General Government Balance by around €665 million of 0.3% of GDP.

12.2 There are concerns that there could be a further deterioration this year. In these circumstances, the Department of the Environment, Heritage & Local Government must ensure that the net local authority position in 2008, and following years, stays within the previously approved borrowing limit of €200 million.

13. Dividend Policy

13.1 There are 27 commercial State Sponsored Bodies (SSBs) in Ireland. Together, these paid €164 million in dividends to the Exchequer in 2007. Most paid little or no dividends to the Exchequer. The total profits of these bodies in 2007 is €1.27 billion out of which an estimated €170 million in dividends falls to be paid in 2008.

13.2 There is currently no overall policy with regard to dividend payment by the various commercial SSBs. The levels of payment being made are not based for example on any investment calculation and are quite modest. An initial examination suggests that the overall amount could reasonably be increased to €300 million for 2009 (broadly 30% of profits) without undue hardship on the commercial SSB sector or damage to their investment plans.

Appendix B

Proposed Motion to Dáil Éireann for debate on Wednesday 9 July and Thursday 10 July 2008

That Dáil Éireann

(i) Commends the Government for the progress made under the NDP as evidenced by the 2007 NDP Annual Report, particularly the substantial investment made in consolidating and enhancing Ireland's economic competitiveness;

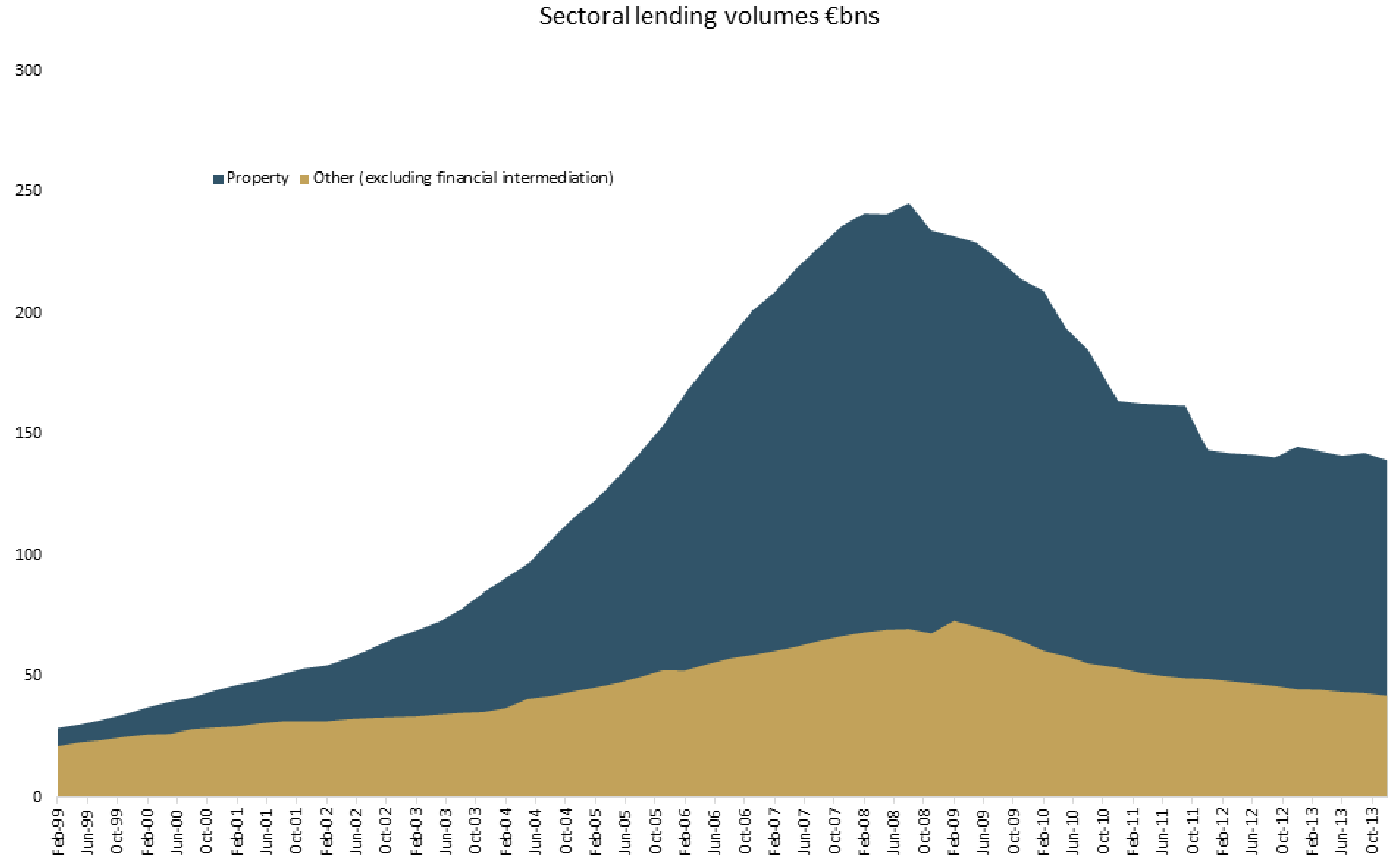
(ii) Acknowledges important economic and social progress made over the last decade and the fact that we face the present economic and fiscal challenges from a position of strength; and

(iii) Commends the Government for the measures it is taking to address the current challenges, particularly the maintenance of policies that support economic and budgetary sustainability, thereby positioning Ireland to benefit from a future upswing in the global economy.

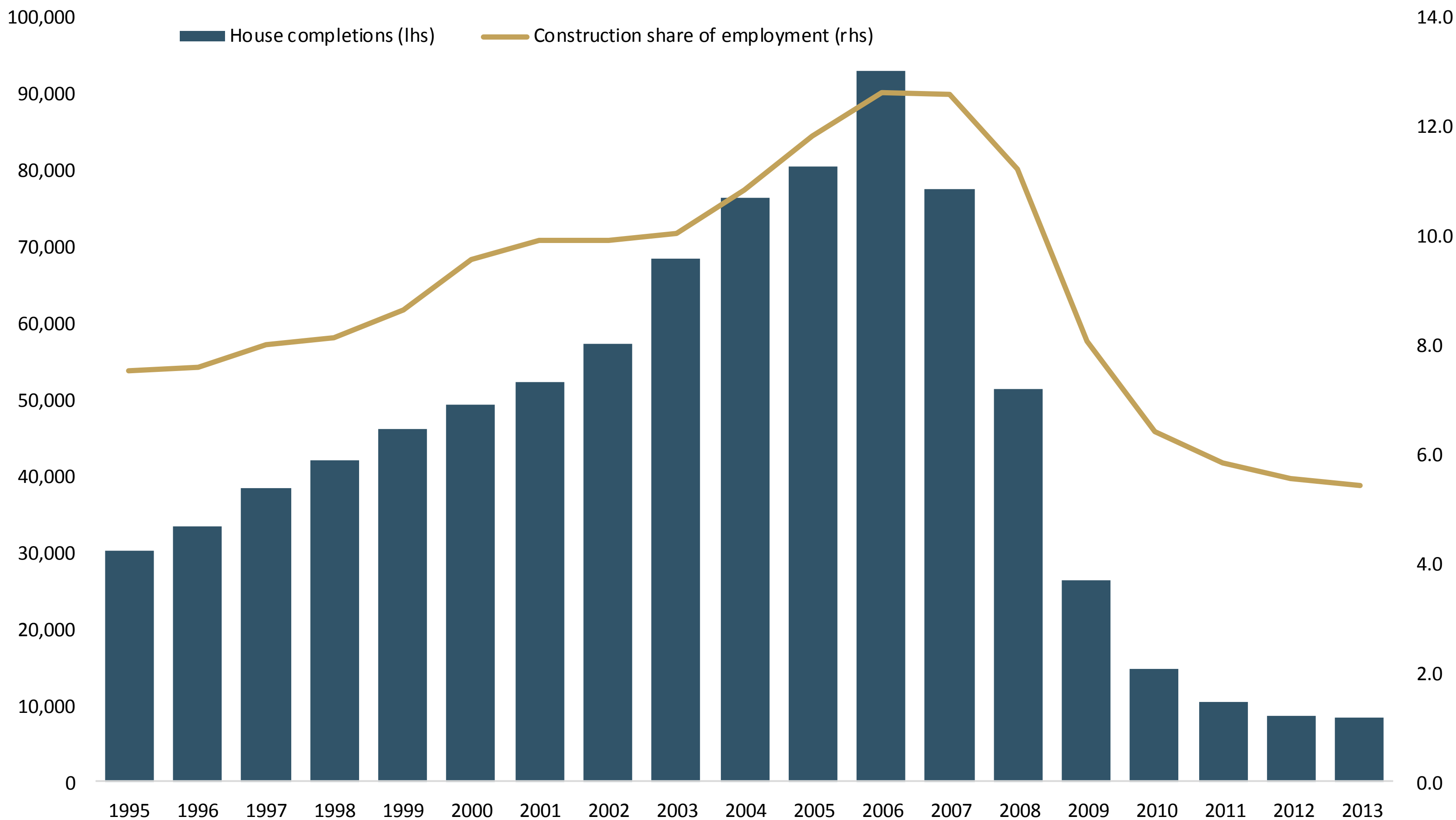
Increases in Public Service Allocations 2000-2008

	2000 €m	2008 €m	% change 2000 - 2008
Social Welfare	6,829	17,741	+160 %
Education	3,716	8,465	+128 %
Health	5,362	15,356	+186 %
Capital Investment	3,930	9,011	+129 %
Total Expenditure	25,925	62,395	+141 %
GDP	105,018	179,989	+71%

Massive increase in credit



Mis-allocation of resources



The Partnership process and the role of the Department of Finance

1 Overview

1.1 This paper summarises the Partnership process which led to a number of national social and economic agreements between 1987 and 2009, including on pay in the public and private sector. It sets out the role played by the Department of Finance in reaching those Agreements and notes, in respect of the agreements from 2000 onwards, the opening analysis of the Department and the key policy commitments and public service pay agreements made in reaching each of those Agreements.

1.2 The series of partnership deals ran from 1987 until their suspension in the context of the austerity measures in 2009. National pay policy, of which Public Service pay policy is a key component, was to a very large extent shaped by the national social partnership process. Partnership deals allowed pay to be addressed in a holistic way as part of a broader agenda of social, economic and fiscal issues. Moderate pay agreements, by reference to cost of living increases, was agreed in exchange for fiscal reform which boosted take home pay, especially in the initial agreements. In later agreements, pay awards were closely tied to wider social reforms and trade union concessions of flexibility around reform in the public service and industrial peace. Because partnership deals involved buy-in from all of the social partners and have tended to include a specific commitment to industrial peace allied to public service reform, they contributed in large measure to the relatively harmonious industrial relations environment that prevailed in the decade to 2009.

1.3 That environment contributed to the moderate way in which public servants, and public service unions, responded to the austerity measures of 2009 and was helpful to the achievement of a negotiated public service pay settlement in 2010, despite the suspension of the formal Partnership arrangements. The Croke Park Agreement commits public service unions to cooperation with delivery of public service reform in return for Government commitments to no further pay cuts and no compulsory redundancies, along with annual pay reviews for public servants based on savings achieved.

2. Background to Partnership process and Agreements between 1987 and 2000.

2.1 While the particular focus will be on agreements reached in the last decade of Partnership, the background to the creation of Partnership and the main content of the Agreements reached between 1987 and 2000 is sketched out below.

2.2 Prior to 1987, post-war wage bargaining in Ireland went through a number of specific phases, summarised in Wallace, Gunnigle and McMahon *Industrial Relations in Ireland* as follows:

	Level of bargaining	**Number of Agreements**	**Name**
1946 – 1970	Industry and local, with some national in four	Twelve	Wage rounds
1970 – 1981	National and supplemented by local	Seven Two	National Wage Agreements National understandings
1982 – 1987	Local and general public agreements	5/6 - varied across	Decentralised wage agreements

		organisations	
1987-2009	Centralised	Eight	Consensus/Partnership Agreements

2.3 The 1970 to 1981 agreements were conducted under the auspices of the Employer Labour Conference which comprised employer (including Government as employer) and union representatives, with the Government as policy maker getting more involved as the agreements progressed. The national understandings however differed from the 7 wage agreements - as well as an employer/union pay agreement, they included an agreement between the unions and employer on a wider range of issues. While the wage agreements provided for flat level increases in wages, there was a high level of wage drift driven by 'Above The Norm' claims.

2.4 Between 1982 and 1987, which coincided with a severe downturn in the economy and large increase in unemployment, wage negotiations were done largely at employment level with settlements varying widely between employments/industries. Government pay guidelines were largely only of relevance in the context of public service pay negotiations.

2.5 Interest was expressed by some on the union side to return to a national wage settlement in 1986/87. The publication of a National Economic and Social Council (NESC) report *A Strategy for Development 1986 – 1990,* which advocated the adoption of an agreed approach to regenerate the economy, was also influential. The NESC contained representatives of employers associations, trade unions, farmers organisations, with civil servants chairing and participating in the discussions. The suggested approach was taken up by the newly elected Government in 1987 and in October 1987 the first Agreement the *Programme for National Recovery* was agreed.

Agreements from 1987 to 2000

2.6 The Agreements, including their main tax commitments are set out below:

Title	Duration	Tax Commitments
Programme for National Recovery	1987 – 1991 (39 months)	Reduction of IR£225 million, including increases in PAYE allowances amounting to IR£70 million. Widening of tax bands and cut in income tax rates to 30% and 53%.
Programme for Economic and Social Progress	1991 – 1994 (36 months)	Reduce bottom rate to 25% (not achieved)
Programme for Competitiveness and Work	1994 – 1997 (36 months)	IR£900 million in tax cuts Reduction from 27% to 26% on standard rate PRSI reduced by 1%. IR£100m cut in tax on business
Partnership 2000 for Inclusion, Employment and Competitiveness	1997 – 2000 (39 months)	IR£900m in tax reductions over 3 years. IR£100m reduction in tax on business.

Pay agreements

2.7 The commitments in these earlier Agreements tended to be predicated on a trade off between wage moderation and reform of the taxation system, with the effect of increasing take home pay for workers. Agreement on pay terms was often reached during discussions between the trade unions and private sector employers, which would tend to determine the outcome for the public service pay agreement, albeit differently timed. However the need to compete in the labour market could, and did, put pressure on public service pay rates.

2.8 Generally speaking, the consistent aim of the Department in the partnership process was to achieve pay settlements that were conducive to the maintenance of national competitiveness, while allowing the public service to attract good quality staff in what was a generally tight labour market up to 2008. The pay terms, as they affected the public service, are set out in Appendix A which lists all the "General Round" (universal) pay increases applied to public servants since 1946.

2.9 The terms of those Agreements assisted in delivering a long period of relative wage moderation across the Irish economy. However, during the late 1990s under Partnership 2000 (and for a period under the Programme for Prosperity and Fairness (2000/2002)) a substantial number of private sector firms reached settlements well in excess of the standard round terms of the agreements, reflecting difficulties in the tight labour market of the time. There were also major strains on wages developing within the public service, due in part to perceptions that the private sector had moved ahead in terms of pay. There was also considerable industrial unrest in the public service in the late 1990s, characterised by leapfrogging and substantial pay claims from different groups.

2.10 Earlier agreements included provision for local bargaining increases in addition to the standard increases. Claims made under this provision were generally based on comparison with what were regarded as analogue grades elsewhere within the public service. The Department wanted to move public service pay determination away from traditional analogues and relativities which severely limited public service employers' abilities to secure increased productivity in return for pay increases. Proposals were developed for the establishment of a body which would examine and benchmark actual jobs in the public service, and recommend appropriate rates of pay, having regard to similar roles in the private sector. This however was divisive among public service unions, which some in favour and some opposed. It was agreed as part of the Programme for Prosperity and Fairness that a Public Service Benchmarking Body would be established to examine public service pay and jobs by reference to comparisons with the private sector. It was also agreed that all outstanding pay claims or reviews would be subsumed by the benchmarking process

Widening scope

2.11 While the Agreements had always had a wider focus than merely pay and taxation, Partnership 2000 included significant commitments on social inclusion measures, as well as the more usual measures relating to pay and taxation. The widening scope was popular with the other actors in the discussions, particularly with the employers as concessions on that side could reduce the pressure for a higher pay award.

2.12 Partnership 2000 also had a special focus on commitments on public service modernisation in return for the public service pay agreement, essentially to underpin the Strategic Management Initiative which was developed in the mid-90s to deliver significant change in the way in which the public service carried out its work.

Additional actors brought in

2.13 An important feature of partnership has been the widening of the organisations involved in the process. In 1993, the Government established a new partnership body, the National Economic and Social Forum to focus specifically on issues of long-term unemployment and social exclusion. Its membership included the longstanding social partners – trade unions, employers associations and farm organisations – and representatives of the community and voluntary sector, as well as members of the Oireachtas (Houses of Parliament). By 1997 the community and voluntary sector had full social partner status (as the Community and Voluntary pillar) as well as participating in the NESC. In 2008 an Environmental Pillar was also added to the process.

Development of monitoring arrangements

2.14 Monitoring arrangements also developed over the course of the Agreements. Under the first agreement, government and the partners developed a light touch process for monitoring the agreement, the Central Review Committee, chaired by the Secretary General to the Department of the Taoiseach. The National Implementation Body (NIB), essentially comprising the Secretary General to the Government and the heads of the trade union and employers' conferences respectively, or senior Finance representatives when the public service was involved, was created in 2001 to oversee implementation of the Agreements and maintain the integrity of the Agreements, particularly in the pay and industrial relations sphere in both the public and private sectors. In addition, under the later Agreements, performance verification groups were established with a view to ensuring delivery of the agreed change programme in each public service sector.

2.15 There was often a tension between the need, perceived on both sides, to ensure delivery of commitments made, and the administrative overhead caused by the burden of servicing review or monitoring groups.

3 Department arrangements to prepare for Partnership Agreements.

3.1 Partnership Agreements had defined periods of operation. The date on which preparatory work for the succeeding agreement would need to start was therefore reasonably predictable. Negotiations for a new Agreement tended to follow the same pattern, with development of a NESC Strategy document by the social partners setting out a shared analysis of economic and social trends, the macro-economic environment and the parameters within which a new programme should be negotiated. Normally lengthy initial discussions particularly on the non-pay social elements would be followed by a short period of intense negotiations to finalise the Agreement with high level political involvement. The negotiations for all Partnership Agreements were chaired and coordinated by the Department of the Taoiseach (Prime Minister). The process was overseen from a political perspective by the Taoiseach and Minister for Finance, and the senior Minister of the smaller coalition parties.

3.2 In the year prior to discussions on the next Agreement an interdivisional group of Principals, representing the key divisions of the Department involved (Budgetary, Expenditure, Pay, Corporate) was established to review the impact of the previous

Agreement and prepare a negotiating strategy on behalf of the Department. This was then reviewed and endorsed by the Department's MAC. It would set the basis for the Department's position on the issues, including public service pay.

3.3 A Memorandum for Government was jointly prepared with the Department of the Taoiseach which would determine the Government position on entering the negotiations. The Minister/Government were then regularly briefed on the discussions, both in writing and at key times verbally. In the Budgetary Strategy Memorandum (usually sent to Government mid-year) the Minister would try to predict the expected cost of any agreement which was likely to be negotiated during the next year.

3.4 One of the first activities in the Partnership discussions usually involved a presentation by the Budget side to the Social Partners of the Budgetary position as a way of indicating to all the negotiators the limits for manoeuvre that would have to be imposed on the negotiations by the prevailing financial parameters.

3.5 During the negotiation of the Agreements, the usual practice was to form an inter-Divisional Group at Assistant Secretary level, and chaired by the Assistant Secretary responsible for Pay, to prepare for the various strands, assess the likely cost implications and monitor developments. This Group included an Assistant Secretary on the Budget side as they would need to include any possible cost implications in their emerging budgetary figures for the succeeding year. The Assistant Secretary Group would hold regular meetings throughout the discussions with additional bi-lateral contacts as required. The Assistant Secretaries actually involved in the negotiations (normally two, dealing with the Pay and non-pay issues) briefed this group on a regular basis.

4 Agreements since 2000

4.1 Since 2000, there have been three overall Partnership Agreements, as well as two interim pay deals. The following description describes briefly the opening analysis of the Department, as established by the Principal Officer Working Group and the key pay and non-pay commitments actually made in the Agreements. These are only a summary and should be read with caution. Each Agreement contained wide-ranging and complex commitments on both sides which cannot be summarised in a document of this length. To illustrate the process, Appendix 2 contains the key preparatory documents, submissions to the Minister and memoranda to Government in advance of the last overall agreement reached in 2006, *Towards 2016*. The following two tables show the breakdown of the pay and pensions bill over the period 2000-2008 and the increase in numbers of public servants over the same period:

		2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2000-2010 increase
Exchequer Pay and Pensions Bill	**€m**	**8,632**	**10,186**	**11,489**	**12,773**	**13,746**	**14,973**	**16,218**	**17,600**	**18,753**	**18,478**	**17,327**	
Increase over previous year	**€m**		1,554	1,303	1,284	973	1,227	1,245	1,382	1,153	-275	-1,151	**8,695**
			18.0%	12.8%	11.2%	7.6%	8.9%	8.3%	8.5%	6.6%	-1.5%	-6.2%	**100.7%**
Increase due to General Rounds	**€m**		637	654	224	538	542	562	873	715	260	0	**5,005**
			7.4%	6.4%	1.9%	4.2%	3.9%	3.8%	5.4%	4.1%	1.4%	0.0%	**58.0%**
Increase due to Benchmarking	**€m**		0	6	592	310	166	128	0	0	0	0	**1,202**
			0.0%	0.1%	5.2%	2.4%	1.2%	0.9%	0.0%	0.0%	0.0%	0.0%	**13.9%**
Increase due to special/local	**€m**		199	0	126	0	0	0	0	0	0	0	**325**
bargaining etc			2.3%	0.0%	1.1%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	**3.8%**
Increase due to other factors*	**€m**		718	643	342	125	519	555	509	438	-535	-1,151	**2,163**
			8.3%	6.3%	3.0%	1.0%	3.8%	3.7%	3.1%	2.5%	-2.9%	-6.2%	**25.1%**
Consumer Price Index Annual % Change			**4.9%**	**4.6%**	**3.5%**	**2.2%**	**2.5%**	**4.0%**	**4.9%**	**4.1%**	**-4.5%**		

* Other factors increases are mainly an increase in numbers up to 2008. 2009 and 2010 decreases are a result of the pension related deduction which is treated as an A-in-A.

Exchequer Funded Public Service Numbers

Sector	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2000 - 2010 Increase
Health	72,829	81,513	92,996	95,679	95,800	98,723	101,978	106,273	110,600	111,770	109,100	**36,271**
%		11.9%	14.1%	2.9%	0.1%	3.1%	3.3%	4.2%	4.1%	1.1%	-2.4%	**49.8%**
Education	65,937	67,845	74,676	77,070	76,989	79,881	83,435	89,263	90,456	94,880	93,706	**27,769**
%		2.9%	10.1%	3.2%	-0.1%	3.8%	4.4%	7.0%	1.3%	4.9%	-1.2%	**42.1%**
Civil Service	32,733	34,068	36,092	37,796	37,276	36,867	36,533	37,156	38,200	39,129	37,381	**4,648**
%		4.1%	5.9%	4.7%	-1.4%	-1.1%	-0.9%	1.7%	2.8%	2.4%	-4.5%	**14.2%**
Security	24,525	24,439	24,268	24,292	24,332	24,828	24,712	25,438	26,090	26,524	25,583	**1,058**
%		-0.4%	-0.7%	0.1%	0.2%	2.0%	-0.5%	2.9%	2.6%	1.7%	-3.5%	**4.3%**
NCSSB's	9,624	10,388	11,086	11,612	11,367	11,095	11,391	11,700	11,798	12,354	11,834	**2,210**
%		7.9%	6.7%	4.7%	-2.1%	-2.4%	2.7%	2.7%	0.8%	4.7%	-4.2%	**23.0%**
Total	205,648	218,253	239,118	246,449	245,764	251,394	258,049	269,830	277,144	284,657	277,604	**71,956**
%		6.1%	9.6%	3.1%	-0.3%	2.3%	2.6%	4.6%	2.7%	2.7%	-2.5%	**35.0%**

Figures shown as at 1 January each year.
Local Authority numbers not included in the Public Service Paybill

5 Programme for Prosperity and Fairness (PPF) 2000 - 2002

Principal Officer Working Group Reports

5.1 Three Reports were produced by the Principal Officer Working Group in 1999 in preparation for the report being prepared by the NESC and the eventual negotiation of the PPF. These Reports were wide-ranging in their discussions of the benefits or otherwise of entering a new Agreement, managing expectations on pay, taxation and expenditure concessions and the need to avoid giving an impression that the Government was committed to negotiating a new programme at any price, issues around competitiveness, wage agreements and moderation, securing agreement to a new approach to public service pay determination (i.e. Benchmarking), timing difficulties and so on.

5.2 On pay, the second report recommended:

- Minimising the level of standard increases and hold them as close as possible to the prevailing rate of inflation
- Maximise the amount paid by way of local bargaining increases
- Introduce sectoral flexibility into public service pay bargaining, allied with a new discipline in public service employers pay decisions.

Overview of commitments in Agreement

5.3 The main commitments in PPF on pay (but see below on renegotiation in December 2000) were:

- Year 1 5½% (min £12 pw)
- Year 2 5½% (min £11 pw)
- Last 9 months 4% (min £9 pw).

5.4 Delivery of the modernisation programme in the Public Service was agreed, with an emphasis on modern performance and HR management systems and with specific actions outlined in the main sectors. The final part of the pay increases were to be paid only in return for agreement on and achievement of specific performance indicators, to be verified by Sectoral Quality Assurance Groups.

5.5 However in light of the increase in inflation after the Agreement was reached (the CPI was projected to be 2.5% but actually 5.6% in 2000), a further agreement was reached in December 2000 on two additional pay awards in both the public and private sector. In the public sector an additional 2% was paid on 1 April 2001 and a 1% lump sum a year later. It was also agreed that the 1st increase awarded under the forthcoming Benchmarking report would be backdated to 1 December 2001.

5.6 The main non-pay commitments related to

- Reducing the burden of tax, and specifically increasing net take home pay, including pay increases, by 25%;
- Commitments on the national minimum wage;
- Increasing social welfare pensions and reforming private and public occupational pensions;
- Introduction of social inclusion measures with a total cost in 2003 of £1.5 billion and with a total cost of not less than £200m in 2003 and other commitments on social welfare payments;

- Investment in infrastructure in line with commitments in the National Development Plan 2000 – 2006,
- Additional supports for enterprise and agriculture;
- Commitments on social and affordable housing,
- Improving partnership arrangements at enterprise level and strengthening institutional supports for partnership and the community and voluntary sector;
- Commitments on childcare.

Pay Benchmarking

5.7 Agreement was reached under the PPF on the key management demand of the establishment of a Benchmarking Body to examine actual jobs in the public service, and recommend appropriate rates of pay, having regard to similar roles in the private sector. This would move public service pay determination away from traditional analogues and relativities which severely limited public service employers' abilities to secure increased productivity in return for pay increases (see paragraph 2.10 above).

5.8 The Body reported in June 2002. Despite demands for increases in the high teens for the majority, it recommended average increases of 8.9% across the public service (actual increases ranged from 0% to 25%), reflecting both pay increases in the private sector, its terms of reference which required it to have regard to "the need to underpin Ireland's competitiveness and develop our economic prosperity on a sustainable basis", and the need to 'rebalance' certain positions following a period of instability in pay awards in the late 90s. The timing of those increases was a key negotiating point in the subsequent agreement, and fell due to be paid over a period up to 2005. The Benchmarking Body was criticised for being too opaque in its decision making.

6 Sustaining Progress 2003 – 2005

Principal Officers' Report

6.1 The preparatory report, in February 2002 (and therefore pre-dating the Benchmarking Body report), emphasised the uncertainty in the economic environment, after the downturn in 2001. Like the reports in 1999, it reviewed wage competitiveness issues which had declined further in the period, although the effects were alleviated by exchange rate declines against sterling. The Report recommended that the Department needs to play a role in the underlying vision for a new Agreement, with that vision centring on moving the economy up to the next level with higher quality jobs, promoting competitiveness, emphasising the need for policy choices between further tax cuts and spending/investment commitments. They suggested a more limited programme, noting a certain fatigue setting in about the complex servicing arrangements under previous agreements and suggested that key demands would be made in relation to poverty reduction and social inclusion, housing, health, education and upskilling, removal of low-paid from income tax net and agriculture spending.

6.2 On pay, the WG recommended no automatic adjustment mechanisms, improved flexibility to take account of changed budgetary circumstances and a possible accommodation to benefit the lowest paid more than others. Public service modernisation would continue to be a key demand of management.

Overview of commitments in Agreement

6.3 The pay element of SP, agreed in February 03, lasted for 18 months only, reflecting the difficulties that occurred with the pay arrangements in a high inflation context under the previous Agreement. The pay commitments with respect to the public service were:

- Pay pause of 6 months
- 3% from 1 January 2004
- 2% from 1 July, 2004
- 2% from 1 December, 2004.

6.4 As with other agreements, the private sector increases were the same but timed differently.

6.5 In addition, 50% of the balance of the Benchmarking pay increases were to be paid from 1 January 2004 and 25% from 1 June, 2005.

6.6 Payment of all of the increases was dependent on cooperation with ongoing modernisation, including specific commitments set out for each sector, and absence of industrial action on matters set out in the Agreement. This was to be verified in each sector by Performance Verification Groups, with non-public service membership.

6.7 Key non-pay commitments included:

- 10 Special Initiatives dealing with cross cutting issues (Housing, Insurance costs, Migration, Unemployed, Educational disadvantage, Waste management, Care of children, the disabled and elderly, alcohol/drug misuse, Inclusion in the Information Society and Child Poverty);
- A new affordable housing initiative to increase supply by 10,000 units
- On taxation, a commitment to continue a PPF commitment to seek that 80% of taxpayers would pay tax at no more than the standard rate;
- Commitments on investment in infrastructure
- Supports for the agricultural sector,
- Increases in social welfare pensions up to 2007
- Increases in the minimum wage
- Measures to control inflation,
- Workplace initiatives

7 Mid – Term Review under Sustaining Progress

<u>Principal Officers' WG Report</u>

7.1 The WG recommended, in advance of the talks in relation to pay which took place half way through the term of Sustaining Progress, that-

- The discussions should be limited to pay and not bring in other issues,
- Given the budgetary position, it was hard to see how anything could be offered on spending or taxation, if pay were to be increased and no new commitments should be made that would increase spending,
- On pay the Department's priority should be an outcome based on low general round increases close to projected inflation rates, which had reduced,

although there was less concern from a narrow public service pay view on floors to increases,
- The competitiveness position had disimproved again and any agreement should not worsen that position. The Report recommended no increase in the National Minimum Wage.

7.2 This approach was endorsed in an Aide Memoire brought to Government by the Minister for Finance which also suggested that, in line with a commitment in Sustaining Progress, an indication of the timing of a further round of benchmarking could be given, as a way of reinforcing benchmarking as the way forward for public service pay determination.

Overview of commitments in the Agreement

7.3 An 18 month pay agreement was reached to conclude for the public service on 30 June 2006. The pay awards agreed subject to verification, were-

-1.5% from 1 June, 2005, except for those earning up to and including €351 per week (€18,315 per annum) where a 2% increase applied;

-1.5% from 1 December, 2005; and

-2.5% from 1 June, 2006.

7.4 In addition, a short list of additional commitments were made, including

- Increases to statutory redundancy payments and maternity benefit,
- Other workplace reforms,
- A date for a renewed Benchmarking exercise to conclude in 2007.

8 Towards 2016 2006 - 2015

A selection of relevant documents is set out in Appendix 2 to illustrate the process of preparing for, and advising the Minister/Government on the draft Agreement.

Principal Officers' WG Report

8.1 In April 2005 the Prinicipal Officers' Working Group produced a report to feed into the preparation of the NESC strategy document. A May report was intended to set the strategy for the discussions themselves. The recommended negotiating approach in the latter was "a position based on the need for moderate wage increases, balanced public finances and an emphasis on developing the infrastructure of the country to underpin economic growth". Although the economic and budgetary outlook was benign, wage competitiveness needed to be tackled. The Report suggested moderate pay increases, more closely aligned with the expected inflation trend over the coming period (anticipated to be around 2%), and suggested pressing for a 3 year pay agreement, with a minimum number of phases (to avoid administrative overhead) and if possible restricted to one annual increase. The linking of public service pay increases to industrial peace, cooperation with flexibility, ongoing change and satisfactory implementation of modernisation should be continued, and Government Departments asked to identify modernisation objectives. The Report also discussed various issues that could be raised in relation to taxation, for example in relation to a tax on second homes, on the commercial semi-State bodies, and on social welfare, capital and other spending.

Overview of commitments given in the Agreement.

8.2 *Towards 2016* included a new social policy framework to address key social changes faced by individuals over the course of their life (children, young adults, working age, older people and people with disabilities). The aim is to design public services around individuals rather than basing them on administrative boundaries.

8.3 A 27 month public service pay agreement was reached (following agreement on similar increases timed differently between private sector employers and the trade unions) which, subject to verification, provided for:

- 3% increase after 5 months (1 December 2006)
- 2% increase after a further 6 months (1 June 2007) except for those earning €400pw or less who received 2.5%,
- 2.5% increase after 11 months (1 March 2008), and
- 2.5% after 6 months (1 September 2008).

8.4 Again, payment of the increases was linked to verified cooperation with public service modernisation, including specific commitments in the various public service sectors.

8.5 Key non-pay commitments included:

- Endorsements of existing or proposed Government policies for additional investment (e.g. National Development Plan 2007 – 2013, Transport 21, Housing Policy Framework,) across the range of Government supported activity,
- Increasing the number of childcare places, improving education and health outcomes for children through expansion of specific services and facilities and increasing income support for poorer children;
- Improving employability for those requiring additional supports, taking additional measures for those without employment, with specific measures for young adults, increasing the lowest rate of social welfare benefit by 2007, taking additional action designed to improve health, including reviewing medical card eligibility, expanding income limits for allowances for carers in the home
- Applying additional resources to Services for older people, increasing funding for the rural transport initiative and supporting health and employment initiatives
- Developing further supports for persons with disabilities.
- Increased funding for the community and voluntary sector
- An increase in the minimum wage from 2007
- Commitments on workplace arrangements, including in relation to private sector pensions and issues around exceptional redundancies,
- New commitments and increased enforcement of workplace rights, including for agency workers.

Benchmarking

8.6 The Second Benchmarking Body reported in December 2007 and concluded that, when account was taken of the value of public service pensions, in general public service pay rates were not below with those of the private sector. Of 109 grades examined increases were recommended for only 15 of them. The recommended increases would have amounted to an average increase of 0.3% in overall pay costs and a total cost of €50m. . However, these increases were not implemented (see paragraph 9.3).

9 Towards 2016 – Review and Transitional Agreement

9.1 As the pay agreement element of Towards 2016 expired in 2008, a further round of discussions commenced in February of that year. On this occasion, a Principal Working Group was not established but a proposed approach was developed within the Department and submitted to the Minister for approval. In April, the Minister for Finance set out for the Government the position he proposed should be adopted in the discussions:

> "(1) in the forthcoming talks on a second pay agreement under *Towards 2016* the public service employers should take the position that
>
> (a) having regard to the emerging less favourable economic and budgetary outlook, the heightened risks to the forecasts, and the need to improve our competitive position, pay increases should be kept at a level which would not undermine our competitive position relative to our main trading partners;
>
> (b) pay increases must be accompanied by improvements in productivity in both the public and private sectors; and
>
> (c) the conditionality and verification provisions applying to public service pay increases under the current public service pay agreement should be retained in any further agreement; and that
>
> (2) in the review of the overall framework agreement *Towards 2016* any adjustments can only be made within existing budgetary parameters and cannot add to net overall expenditure commitments."

9.2 In advance of the expiry of the 1st pay agreement under Towards 2016, a 21 month pay agreement was reached between the social partners in September 2008.

9.3 The pay agreement for the public service was:

- A pay pause of 11 months from the expiry of the last phase of the first module under Towards 2016;
- An increase of 3.5% from 1 September 2009; and
- An increase of 2.5% from 1 June 2010 - except for those earning up to and including €430.49 per week (€22,463 per annum) on commencement of the second phase where a 3% increase will apply.

9.4 In addition, the awards made under the Second Benchmarking would be paid to the grades involved

- 5% from 1 September 2008, or if the total increase was less, the full increase from that date, and
- The payment of any balance to be discussed in the context of a future pay arrangements.

9.4 Other key commitments made in the Agreement were-

- in the context of the deteriorating macroeconomic and fiscal situation, a shared analysis of the economic and fiscal situation and agreement that certain strategic investments would have to be reviewed and re-prioritised in light of the reduction in projected economic growth,
- the establishment of various forums to progress various commitments made in Towards 2016,
- the reestablishment of the Anti-Inflation group,
- commitments in relation to the workplace, including measures designed to address the increasing levels of unemployment, on compliance with employment law standards, on immigrant workers and on agency workers and employment agencies,
- a structure for handling pensions policy,
- a reaffirmation of commitments made on public service modernisation and a new commitment to implement the basic principles of the OECD Review of the Public Service in Ireland, *Towards an Integrated Public Service*
- A commitment to review jointly the Benchmarking process, which acknowledging that the principle of benchmarking remains appropriate.

9.3 In light of the developing economic and fiscal situation, all pay awards were suspended in early 2009. The social partners suspended participation in the social Partnership arrangements itself shortly after. A public service pension levy was introduced in 2009 which amounts to an average reduction of close to 7% for public servants. In addition a reduction in pay amounting to an average of about 6% was applied to public servants with effect from 1 January 2010. The pay reduction produced a saving of about €1bn in the public service paybill. Before the Budget, there were discussions with the public service unions about achieving a reduction of this order on an agreed basis. It appeared that the unions would have been willing to co-operate with this, provided the saving was not achieved through reductions in pay rates. They proposed that savings be achieved mainly through the application of unpaid leave. However, this approach did not prove acceptable to Government and reductions in pay were applied through legislation.