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

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THEME: C1

Effectiveness of the ECOFIN and Domestic Standing Group (DSG) (Central Bank, Financial Regulator and Department of Finance)

LINE OF INQUIRY: C1b

Formulation and reaction to crisis simulation exercises

COUNCIL OF
THE EUROPEAN UNION

Brussels, 14 November 2007

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LIMITE

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ECOFIN 387

DRAFT MINUTES [1]

Subject:	**2822nd** meeting of the Council of the European Union **(ECONOMIC and FINANCIAL AFFAIRS)**, held in Luxembourg on 9 October 2007

[1] Information relating to the final adoption of Council acts which may be released to the public is contained in Addendum 1 to these minutes.

ANNEX

Re: Item 6 on the agenda – Developments on the economic and financial situation

REPORT FROM THE ECONOMIC AND FINANCIAL COMMITTEE

Financial markets situation

– Key issues and follow-up actions –

1. RECENT DEVELOPMENTS

1. Financial markets have been in turmoil since August, amid a sharp decline in investors' appetite for credit risk. The turmoil was triggered by financial losses due to defaults in the US market for sub-prime (i.e. low credit-quality) mortgages. These losses have been transmitted rapidly across the global financial system via the markets for complex financial instruments. The opacity of these instruments, combined with credit risk dispersion, has made it difficult to identify the exact size and location of losses, thereby undermining investor confidence in financial markets more generally. The functioning of money markets has been particularly disrupted, requiring considerable interventions by major central banks into the interbank markets to restore orderly conditions by providing liquidity.

2. Most recent evidence suggests that conditions in financial markets have partially stabilised, but that the situation remains uncertain. The evolution and duration of the current market turbulence and the resulting impact on credit conditions will depend to a large extent on the eventual scale and distribution of financial losses. For this reason also, it is difficult to quantify the likely macroeconomic impact of the turmoil. The performance of the global economy was strong in the period ahead of the turmoil and this growth momentum is likely to be sustained through the remainder of 2007, also for the Euro area and EU economies. However, downside risks have increased and some softening in economic growth in the EU would seem likely in 2008, reflecting both tighter financing conditions and the likelihood of a slowdown in the US economy which would be only partly offset by continued buoyancy in the larger emerging economies.

3. The possibility of financial turbulence, linked to a re-pricing of risk towards more sustainable levels in some markets where valuations appeared to have become stretched, had been identified at an earlier stage. Nevertheless, the specific features of the turbulence and its transmission mechanism were not anticipated and revealed a number of weaknesses, in particular in the markets for complex financial products, which have become rapidly illiquid in conditions of stress. This is the first serious market turmoil since the rapid expansion in the use of these products. The situation continues to unfold and the Ministers of Finance, Governors and Supervisory Authorities are carefully monitoring developments in financial markets and the economy as a whole.

4. In this context, it is still too early to reach final conclusions on possible regulatory and/or supervisory responses but, a preliminary set of key issues to be further analysed and addressed has been identified by the EFC. Some of these issues are already under review by the Commission and supervisory authorities at the EU and global level. Other issues may come to the fore that need to be reviewed. The ongoing financial turbulence adds urgency to this work.

2. KEY ISSUES TO BE ADDRESSED

5. Financial innovation contributes to the efficiency of financial markets by facilitating the spreading of risk, but it also creates new challenges for regulatory and supervisory authorities. Overall, the EU regulatory-supervisory framework and cross-border cooperation in respect of exchange of information have functioned relatively well. Still, an important feature of the recent turbulence has been the lack of information, which raises issues of transparency in the markets for complex financial products as well as questions about how these products are valued, monitored and treated within the framework for prudential regulation and supervision.

- **Enhance transparency for investors, markets and regulators**

6. The absence of accurate and timely information on exposures to credit risk has been a key factor in the generalised loss of investor confidence in financial markets since August. Questions about the adequacy of transparency have been raised in several respects, including: (i) information provided to individual investors and the broader market by special purpose vehicles (SPVs), i.e. conduits and Structured Investment Vehicles (SIVs) involved in the securitisation process; (ii) bank disclosure of securitisation operations and exposures to SIVs, (iii) complexity in the structuring and measurement of risk in structured finance products as well as difficulties in valuating these products; and (iv) opacity in the functioning of markets for complex financial instruments. Supervisors and regulators need to examine how and where progress can be made in improving transparency, including in arrangements for information exchange among themselves.

- **Improve valuation standards, including of illiquid assets**

7. The ultimate responsibility for the valuation and accounting treatment of assets lies with institutions holding the assets. However, supervisors, accounting standard setters and other relevant authorities also play an important role from a prudential perspective. More work is needed on standards to ensure reliable valuation of assets, particularly of those assets where markets are potentially illiquid in time of stress, while ensuring compatibility with international financial reporting standards.

- **Reinforce the prudential framework, risk management and supervision**

8. In recent years, financial markets have evolved both in terms of size and sophistication and it is essential that the framework for prudential regulation, supervision and financial stability arrangements keeps pace with these developments. In this context, the EU Finance Ministers have since 2003 been developing the arrangements for financial stability in the EU. On 9 October, the ECOFIN Council agreed on common principles and further actions to enhance the effectiveness of financial stability arrangements and the ability of authorities to respond jointly in serious disturbances in EU financial markets. In Spring 2008, a new Memorandum of Understanding (MoU) will be signed

between Heads of Competent Banking Supervisory Authorities, Central Banks Governors and Finance Ministers in the EU. The Commission and Member States will also work toward enhancing the availability of the tools, necessary in preserving financial stability in Member States and in ensuring their functioning across-border between relevant parties. The possible enhancement of Deposit Guarantee Schemes within the EU to ensure their effectiveness in stemming a loss of confidence in the financial system also needs to be examined.

9. The Lamfalussy framework will be reviewed in December 2007. This review will provide an opportunity to take stock of progress made and to identify further steps that would ensure that the EU framework for prudential supervision evolves in line with market developments.

10. The Capital Requirements Directive, which implements the Basel 2 framework in the EU, will fully enter into force on 1 January 2008. It will help to improve transparency, particularly in the context of securitisation), and will instil greater discipline in the transfer of risk from credit institutions, thus reducing the scope for regulatory arbitrage and limiting capital relief to operations where risks are effectively transferred. Nonetheless, the significance of off-balance sheet exposures, liquidity risk and reputational risk in the recent financial turbulence suggests a need to further reflect on regulation and oversight in these areas, e.g. liquidity exposures to special purpose vehicles, assessment of risk transfer, practices for liquidity management, procyclical effects of credit market developments and proper prudential treatment of credit risk embedded in structured products held for trading.

- **Improve market functioning, including rating agencies**

11. Recent events underscore the importance of a better understanding of the role of securitisation within the financial system, based on comprehensive market statistics, and of how the so-called "originate and distribute" model, where banks do not hold the loans they originate but repackage and securitize them, has impacted on the incentives structures of credit markets, in a context characterised by a shift from the more traditional retail to interbank borrowing.

12. A better insight into the incentive structures, including possible conflicts of interest and disincentives to perform proper due diligence, faced by credit originators, credit rating agencies and other market participants is required. In this context, the EU should examine the role of credit rating agencies, in particular as regards structured finance instruments, conflicts of interest, transparency of rating methods, time-lags in rating reassessments and regulatory approval processes. In addition, excessive reliance solely on credit ratings by investors without carrying out due diligence or conducting further own risk assessments as well as the transparency of rating methods in managing their risk has to be dealt with.

13. Work is being pursued on the issues mentioned (a roadmap is included in this annex) and first conclusions can be expected in spring 2008. A wide range of policy options should be considered alongside the necessary initiatives from the industry to improve transparency, risk management practices and, in adopting self-regulatory action.

3. COOPERATION AT THE GLOBAL LEVEL

14. Many of these issues must be addressed in an international context, including through the Financial Stability Forum (FSF). The EU and its Member States must play an active role in global discussions with the key partners and should work towards enhancing the efficiency and stability of international financial markets, including from the perspective of the Single European Market.

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ROADMAP

This roadmap identifies the preliminary set of key issues to be analysed and addressed following the recent market turbulence as well as a timeframe for final conclusions and action. The relevant EU fora (Commission, level 3 committees, FSC and ECB) are invited to carry out this analysis and draw preliminary conclusions. They should work closely with relevant international bodies such as the G10-regulators (for CEBS), IOSCO (for CESR), international accounting fora and the FSF, which is preparing a report on related issues for the April 2008 meeting of the G7. The industry should also be consulted on a number of issues.

The Commission is invited to closely follow these different work streams so as to shape its views, ensure consistency, including with its own work programme and, formulate and propose appropriate policy responses.

The various actions identified should be co-ordinated by the EFC. Following a preliminary discussion at the FSC, the Commission and the FSC are invited to report on progress to the March 2008 EFC. The EFC will report to the April 2008 Informal Ecofin, which will provide further guidance, including in respect of the preparations of the ensuing G7 meeting.

ROADMAP:

(1) Enhance transparency for investors, markets and regulators by

– Examining whether public disclosure of types and amounts of securitisation exposures, of significant individual transactions and of sponsoring of Special Purpose Vehicles' exposures by banks under Capital Requirements Framework (Basel2/CRD) is sufficient;	Mid 2008
– Where necessary, organising comprehensive, frequent relevant statistical data on credit markets, asset pricing for authorities and, where appropriate, the public.	Mid 2008

(2) Improve valuation standards by

– Agreeing on a common approach to the accounting valuation of illiquid assets; and,	Mid 2008
– Considering improvements in market valuations more generally, together with the implications for risk management practices by banks;	Mid 2008
– Examining the deployment of sound asset valuation standards in non-bank investors (e.g. asset managers, pension funds etc), particularly in relation to (potentially) illiquid assets.	September 2008

(3) Reinforce the prudential framework, risk management and supervision in the financial sector by

– Reviewing possible enhancements of Deposit Guarantee Schemes in the EU, including issues related to communication between authorities and depositors;	Mid 2008
– Assessing the level of risk management standards in non-bank investors (e.g. asset managers, pension funds), particularly in relation to potentially illiquid assets;	September 2008
– Examining possible enhancements of liquidity risk assessment and management by banks by taking forward the forthcoming Basel Committee recommendations, to ensure banks are well equipped to withstand stressed market conditions;	End 2008
– Examining the need for a wider concept of concentration risk, including wholesale and interbank markets, and intra-group exposures, as part of the EU Large Exposure Review;	End 2008
– Examining the Capital Requirements Framework for banks' liquidity exposures Special Purpose Vehicles to reflect lessons concerning banks', including (1) incentives to move risk off-balance sheet; (2) regulation and management of liquidity and reputational risks transferred to these vehicles; and, (3) valuation and treatment of these vehicles and forced asset buy-backs;	End 2008 (depending on G-10)

– Identifying and removing any regulatory arbitrage opportunities and examining the Capital Requirements Framework for banks' own trading book exposures, including the treatment of "warehousing" and "pipeline" risks;	End 2008 (depending on G-10)
– Considering how to improve global cooperation between supervisors, including outside the EU, taking into account the proposals to enhance cooperation and by renewing and improving crisis management tools as set out by the ECOFIN on 9 October 2007 based on EFC recommendations.	End 2008

(4) Improve market functioning, including the role of credit agencies, by

– Examining the role of credit rating agencies, in particular as regards structured finance instruments, conflicts of interest, transparency of rating methods, time-lags in rating reassessments and regulatory approval processes;	April 2008
– Examining the incentive structures in credit markets and the implications of the "originate and distribute" models of banks for credit markets;	Mid 2008
– Examining rules covering the origination and (mis-) selling of mortgage credit;	Mid 2008
– Examining the organisation of non-regulated debt markets.	Mid 2008

Conventional wisdom on crisis management

- Process viewed in a 'linear' way
  - Request to CBFSAI for Emergency Liquidity Assistance (ELA) provision from financial institution
  - Lead responsibility for crisis management during that phase residing with CBFSAI
  - Department's direct involvement predicated on the emergence of 'solvency' as opposed to 'liquidity' issues (i.e. need for public funds)

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Lessons learnt

- If confidence fragile then small institution could trigger systemic difficulties
- 'Market discipline' not a useful tool in current context
- Emergency Liquidity Assistance likely to trigger requirement for open ended State guarantees and possibly wider systemic problem
- Liquidity problem can quickly trigger solvency concerns

Framework for crisis resolution

- Key Principles:-
  - Earliest possible identification and communication to Department of possible threats to financial stability
  - Need to maximise options for early intervention to pre-empt requirement for ELA (by which time banks' financial position is unlikely to be retrievable)
  - Swift resolution presented as *fait-accompli* critical[1]
  - Open-ended State guarantees exposing the Exchequer to the significant fiscal risk are not regarded as part of the toolkit for successful crisis management and resolution
  - There are circumstances where such guarantees may be unavoidable to maintain confidence in the overall financial system

[1]CB/FR to have, on a continuous basis, all information for ongoing assessment of sustainability of financial institutions

Main resolution options

- Market-based solution preferred option - depending on scale may require involve Irish banks, international banks, outside investors
- Nationalisation is sub-optimal, but may need to be considered as a last resort to pre-empt requirement for extended period of ELA support and attempted public 'market' rescue carried out in the public domain
- Examinership is a legal option under insolvency law but in present climate would be seen to reflect very negatively on entire banking system

Legal assessment

- Legal advice obtained from the Office of the Attorney General on key aspects of the proposed framework
- In overall terms legal assessment is enabling, but will require a number of participants (outside the Dept's control) to agree/approve the resolution

Market Abuse Directive/Takeover Rules/Nationalisation/Guarantees

- A financial institution could postpone disclosing to the market information that prompts a negotiation for ELA, provided that:-
  - The institution had a legitimate interest, not be likely to mislead the public (OAG) and able to ensure the confidentiality of the information
- Public authorities could facilitate the non-public takeover of a distressed financial institution **<u>if</u>** the Takeover Panel granted a derogation from its Rules given the exceptional circumstances
- CBFSAI itself has express statutory power to purchase shares in a credit institution with the approval of the Minister for Finance
- Statutory authority to issue a Ministerial guarantee would need to be examined.

State Aid

- CBFSAI Liquidity support on commercial terms probably not a State Aid
- Other financial assistance, including guarantees not provided on commercial terms prima face likely constitute State Aid
- October 2007 Ecofin conclusions invite the Commission to clarify when a major banking crisis might be considered by the Commission as falling within Article 87(3)(b) 9 (“a serious disturbance of the economy”)

State Aid Cntd.

- EU Commission view of State aid control
  - Pursue a legitimate public interest
  - Well designed to deliver on the objective of common interest
  - Distortion of competition is limited
- Rescue and Restructuring Guidelines Article 87(3)(c)
  - Emergency liquidity (Normally Loan guarantees/loans), limited time period (6 months)
  - Restore long term viability, Avoid undue distortion of competition, limited to the minimum
- Article 87(3)(b) Crisis affecting the economy as a whole "...banking crisis will normally not be found compatible on the basis of Article 87(3)(b)

Conclusions

- Primary objective is to safeguard public / international confidence in stability of Irish financial system
- It is in the interests of the public that the situation is solved before it enters the public domain in order to prevent contagion
- Legal advice confirms that proposed framework for crisis resolution should be broadly legally feasible

European Union
Financial Services Committee

Brussels, 8 February 2006

NON PAPER for discussion

from :	Chairman
to :	Members of the FSC
Subject :	Update of the FSC Survey on national arrangements for Financial Stability and Crisis Management – Assessment and policy issues

1. Background

1. The EFC Report to the Scheveningen 2004 Informal ECOFIN on "Next Steps in developing the EU framework for financial stability and crisis management"[1] set out priorities for 2005-2006 at both EU and national levels in the follow up of the Brouwer reports. The Report drew on extensive work carried out by the FSC, in particular the May 2004 outcome of the Survey on national financial crisis management procedures and the subsequent operational conclusions in the July 2004 Report by the FSC Vice-Chairman[2].

2. At the national level, the recommendations in the EFC Report were the following:

[1] ECFIN/CEFCPE (2004) REP/50244 FINAL

[2] "Developing a framework for managing financial stability problems in the EU"- 30.06.2004 (not published)

- *"The EFC urged all Member States to review their national arrangements and to enhance them where needed, e.g. by creating domestic standing groups* (composed of all relevant authorities, including Ministries of Finance), *and, in this context, to develop contingency plans*".
- *"supervisors and central banks are invited to further develop stress tests and share the aggregate results with finance ministries on a periodic basis*".
- *"The effectiveness of national and EU level crisis management arrangements should be tested by crisis simulation exercises…*"

The FSC was invited to monitor progress in this area and report back to the EFC.

3. In October 2005, the FSC members were invited to update their answers to the first FSC survey on national arrangements for financial stability and crisis management, indicating those that had been changed since November 2003, taking into account the conclusions of the 2003-survey and the new MoU on co-operation between the Central Banks, Banking Supervisors and Finance Ministries of the European Union in Financial Crisis Situations.

4. The synoptic analysis of the responses to the update of the survey is presented to the FSC in a separate non-paper. On the basis of that analysis, the present non-paper has been elaborated for the attention of FSC members. Following the examination in the FSC, a revised non-paper setting out the position of the Committee will be transmitted to the EFC

2. Assessment

5. The EFC Report put forward a comprehensive and ambitious programme of action with the aim of setting up adequate mechanisms for financial stability and crisis management to deal with a more integrated and complex financial system. In short, what was decided was to build an EU framework with the involvement of all relevant authorities through an MoU, contingency planning and crisis simulation exercises, and to complement this with national systems along the same lines, even if the detailed set-up of national arrangements is left to the discretion of Member States.

6. Progress has proceeded rapidly at the EU level, with the signature of the MoU in July 2005 and the preparations for the April Crisis Simulation Exercise well advanced. At the national level, however, the results of the Updated Survey show that **progress is uneven and from an overall perspective, unsatisfactory**.

7. First of all, the degree of compliance with the request of the FSC to update the 2003-2004 survey has been disappointing, considering that two months were given for completing the work. On the expiry of the set deadline (16 Dec.2005), only 9 Member States had responded on time. To date, only another 10 Member States have provided responses, while the answers from 6 Member States are still missing. Insofar as this stock-taking survey is concerned, this situation has made it more difficult to come up with a complete and accurate picture of the state of, and the progress in, national systems for crisis management. Furthermore, it may illustrate an insufficient level of commitment and a delay in the underlying implementation work following the aforementioned EFC recommendations in a number of Member States.

8. The analysis of the responses to the Updated Survey received to date shows that progress has been uneven. In several Member States national systems have been revised and work has been carried out to comply with the recommendations in the EFC Report, starting in many cases with the creation of domestic standing groups with the participation of Ministries of Finance. Yet, there are also some Member States where the absence of any significant change or initiative leads to the reasonable presumption that the revision has not taken place.

9. Even after taking progress into account, national systems in a large majority of Member States are still quite far away from the standards set in the EFC Report. With the information available at this stage, **only four Member States (DK, FIN, SE and UK) have systems that can be reasonably considered to comply fully with all the standards**[3].

10. Given the political priority conferred by ECOFIN to crisis management, the FSC should recognise that **progress is unsatisfactory and much remains to be done**. The discussion should hence focus on **how to give momentum to bringing national systems in line with the recommendations**.

3. Policy issues

<u>Agreeing on realistic deadlines with clearly defined objectives</u>

11. Putting in place an effective system to deal with financial stability and crisis management is a challenging task for Finance Ministries. It demands an intensive use of time and human resources; it is technically complex and it entails a substantial effort of co-ordination with

[3] Consider the first three columns in the overview table provided in Annex 1 to the Non-paper providing a synoptic analysis of the responses to the update of the 2004 Survey.

central banks and supervisors. Furthermore, **as the 2004 Survey showed, in a majority of Member States the involvement of Finance Ministries in these issues was limited or non-existent**, which raises the cost of building a system along the lines recommended in September 2004. The conclusion is that **fulfilling the goal set in the EFC Report will take time**.

12. The build-up of an effective national system has a **logical sequence**, starting with the creation of a domestic standing group, which is undoubtedly the cornerstone of the whole framework[4]. The group then develops national contingency plans and regularly examines the aggregate results of stress tests[5]. The functioning of the system is then tested periodically by crisis simulation exercises arranged both at national and EU levels. This sequence could be used to **set deadlines** for complying with the main standards in the EFC Report in the following way:

    - **[By July 2007]**. Creation of a **domestic standing group** and development of **national contingency plans**. It should be clear that the groups should comprise the Ministry of Finance and that the plans should cover all participating authorities and not just central banks and/or supervisors.

    - **[By January 2008]**. **Crisis simulation exercise** and **sharing of aggregate results of stress tests with Finance Ministries**. The exercise should involve at least those authorities belonging to the standing group.

Do Members agree that pragmatic deadlines will help to give momentum to the process? Do Members consider the proposed course of action and deadlines appropriate?

Developing a positive peer pressure mechanism

13. The only tool to promote compliance with the EFC Report recommendations is **peer pressure**. Regular assessments of Member States systems, with a possible scoreboard for consideration by EFC-FST, are supposed to provide sufficient incentives for Member States to fulfil these recommendations. Yet, the risk of relying exclusively on this approach is that the focus would

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[4] Paragraph viii of the Executive Summary of the Vice-Chairman Report reads "The report recommends that each Member State should, as a matter of priority, create standing domestic groups of all sector supervisors, the national central bank and the Ministry of Finance (or other relevant Ministry) for information exchange and for preventing, evaluating and managing potential systemic problems".

[5] As proposed in the Vice-Chairman Report, the stress tests could in the future be based on shared assumptions among authorities from Members States such as specific features to be tested and a common set of macro- and microeconomic assumptions.

tend to be more on the score in a table that on the real improvements in the components of the crisis management system.

14. Giving a clear picture of progress in each Member State will of course be a necessary feature of the process. But there could be merit in **complementing this traditional peer pressure** mechanism with a more positive side, **by making the FSC discuss on the specific problems, practices and experiences** in developing each of the elements of the crisis management system. For instance, a specific point on domestic standing groups could be included in one of the **2006** FSC meetings; one or two Member States (preferably in different stages of compliance with the standards) could be invited to present their experience. This kind of discussion and best practice-sharing could help FSC members to speed progress as well as to make their systems more effective. **At a later stage**, discussion could also cover experience drawn from the practical set up of national contingency plans and step up to good practice in preparation for the national crisis simulation exercises. The **EU-wide crisis simulation exercise** (April 2006) could also be a complementary source of inspiration for initial discussions on this latter topic.

Do Members see merit in developing this positive peer pressure mechanism? Do members consider that examining, in the FSC, experiences in creating effective domestic standing groups and in developing contingency plans, stress tests and simulation exercises could be useful?

A lighter monitoring process

15. The FSC survey on national arrangements for financial stability and crisis management has been an extremely useful tool to get a comprehensive view of the state of national systems and to base the recommendations to improve them. Yet, keeping the survey to monitor progress from now on could be unnecessarily burdensome, as evidenced by the outcome of the Update. If the **deadlines proposed** above are retained by the FSC, the Secretariat would suggest that, unless there is any objection to this new approach, **Member States should just be asked to give a short account of the compliance with the corresponding element some time before the deadline expires**. This simplified mechanism would avoid having to rely on supervisors and central banks to report the progress, which may otherwise significantly complicate the task for FSC members.

Do Members agree that the monitoring process should be streamlined?

INTRODUCTION

"We believe that financial crises can be foreseen, their magnitude can be estimated, precautionary steps can be taken to prevent crises, strategic options can be devised and implemented and corrective measures can be taken to lessen the storm's ultimate impact. Leaders with the foresight to observe and react effectively can manage a crisis strategically before, as well as after, a crisis hits."[2]

This Review has its origin in the work going on at European Union level in regard to the prevention, management and resolution of financial crises in the Member States of the European Union. Specifically all member States have been enjoined by the Economic and Financial Committee to put arrangements in place to prevent, manage and resolve financial crises. Secondly member States have been requested to conduct financial crisis simulation exercise to assess the organisational response capability of national competent authorities to any future financial crises that has systemic implications.

This imperative resulted in the preparation of a Black Book by the CBFSAI setting out their views on the arrangements that should be put in place to manage and resolve any systemic financial crisis that may arise in Ireland. Issues in relation to the prevention of financial crises are being dealt with separately mainly in the context of the development of the regulatory and supervisory regime for financial services at European Union level. Lesser financial crises where there are no systemic implications or where the entity is not deemed too big to fail (TBTF) will be the subject of a further exercise. Many of the recommendations made here, will however, have relevance to those situations also. The Black Book exercise is to be welcomed even in its incomplete form. It provides an excellent starting point from which to devise an optimum strategy for dealing with management and resolution of systemic financial crises in Ireland.

The Black Book makes certain tentative suggestions about the role and function which the Department of Finance and the Minister should play in the resolution of a major financial crisis. The Black Book is still being developed so cannot in any sense be regarded as a complete or final work. The major drawback of the Black Book is that it is mainly focussed on the decision-making procedures and devotes no time to the optimum structures and systems that should be put in place to deal successfully with a financial crisis. Furthermore strategy as to how the crisis might be managed and resolved is compressed into one recommendation that the State provide a blanket guarantee to allow the rescue to be effected. The manner in which other key players in the financial system could share in the cost of and the management and resolution of the crisis in not elaborated. For these reasons BFI Division decided to conduct a review of national organisational capability for the management and resolution of a financial crisis.

[2] Dangerous Markets - Managing in Financial Crises. Dominic Barton, Roberto Newell, Gregory Wilson.

Objective of Review

The objective of the Review is to ensure that the Department of Finance and its related bodies are properly prepared to deal efficiently and effectively with any future financial crisis of systemic proportions. Its primary value at this stage is to highlight lacunae in the preparedness of the Irish regulatory, monetary and administrative Systems to deal with a financial crisis. While the focus of the Review is on TBTF failures or systemic failures, many of the recommended changes are applicable also to less systemically relevant crises. The Review will

- Present senior management with a comprehensive overview of the structures, systems, powers and procedures currently available to deal with the management and resolution of a systemic financial crisis;
- Examine the strength and weaknesses of existing arrangements;
- Make recommendations to facilitate optimum decision-making, management and resolution of a financial crisis.
- Recommend that the necessary steps be taken now to put in place the legislation that will allow the Minister and other key actors to take the appropriate decisions in a crisis situation without fear of litigation or of acting ultra vires Ministerial powers or Constitutional provisions.

Rationale for Recommendations

This Review is prepared on the basis that any legal ambiguities arising in the role, function, powers, responsibilities and accountabilities of the key actors should be put beyond doubt before any possibility of a financial crisis arises. It is suggested that the Financial Services Legislation Consolidation / Modernisation exercise be availed of make the necessary legislative change. Rather that adopting a irrationally exuberant view on the possibilities offered by the use of existing powers from a diverse range of sources, a constructively critical stance is taken in relation to identifying fault-lines in the existing structures, systems and processes. In essence the focus is on finding the structural, systemic and procedural weaknesses. To do otherwise would be to expose the Minister and the Secretary General to an unacceptably high risk level of risk in regard to the general discharge of their macro-economic management responsibilities and accountabilities.

Methodology

Our choice of methodology for the Review was motivated firstly by a desire to move away from precedent-based or perceived self evident 'We know best' decision-making approaches. A second emphasis is to provide evidence-based solutions and to identify and introduce internationally accepted analytical frameworks and best practice.

The Review takes an organisational development approach to crisis management and resolution and adopts two principle tools from the organisation development repertoire. These are a vertical role analysis and a horizontal 'process engineering' look at the decision-making process.

Vertical Role Analysis

The vertical Role Analysis looks at the Role, Functions, Powers of each key player in the management and resolution process. It aims to identify any gaps in the statutory roles, functions and powers of the key players. It also examines what role the private sector can play in the resolution and management process. A subsidiary aim is to identify the strategies, structures and systems that would be necessary to lock the private sector into the response mechanism in advance of any major financial crisis happening. Burden sharing in relation to the cost of resolving a financial crisis is also considered.

Horizontal examination of decision-making process

A process analysis has been undertaken in regard to each step in the decision-making process. The analysis is designed to

- establish the critical steps in the decision-making process;
- test for any weaknesses in the perceived role, function, powers and responsibilities of key actors;
- identify the essential variables at each decision-making step;
- identify the analytical decision-making frameworks that would summarise in readily assimilable form the main features of the financial crisis and its wider economic and social impacts; and
- ensure that the decision-making procedure observes the fundamental principles of the separation of powers set out in national legislation.

Structure of Review

The report comes in thee parts as follows.

Part 1: This is the main body of the report entitle *'Review of* National Organisational Capability for the Management and Resolution of Systemic Financial Crises' in Ireland. This Part at the structures, systems, procedures and analytical tools that should be available to the Minister to respond to a systemic financial crisis. It examines the following major themes in detail:

Section I: deals with a number of thematic considerations under the heading**:** Theoretical, Conceptual and EU Competition Considerations. It considers what is meant by financial stability, examines the stages in a financial crisis and provides a summary of EU Competition law applicable to rescue operations launched by Member States to resolve financial crises. It also examines the utility of the moral hazard and constructive ambiguity in the preparation of in the preparation of a financial crisis management and resolution framework;

Section II: looks at financial crisis resolution precedents from at home and abroad. In particular it will examine the lessons arising from the management and resolution of the financial crisis arising from collapse of the Insurance Corporation of Ireland in 1985. An alternative scenario is presented by examining the macroprudential structures and systems in place for the management and resolution of financial crises in the United States of America.

Section III: considers contextual and situational issues including the Characteristic of the Irish Financial System and the changes in the System Architecture. It looks at the changes to the overall governance and accountability structures that have been put in place since the last major financial crisis in Ireland. It suggests that a paradigm shift has occurred in the accountability framework. The contextual backdrop therefore provides the appropriate scenery against which the role, responsibilities, duties and accountabilities of the key actors can be analysed.

Section IV: examines the role, functions of, powers and accountabilities of key players with particular emphasis on the identification and amelioration of any gaps. It also discusses the principles that should inform the Government's involvement in the management and resolution of financial crises.

Section V: highlights a number of issues in which the Department of Finance will play a critical role and the preparations necessary to enhance its effectiveness in discharging those responsibilities.

Section VI: sets out the recommendations for future action arising from the Review. They include a wide range of legislative change to allow maximum flexibility and an appropriate mix of interventions to be taken in relation to

Single events threatening financial stability i.e. the collapse of a single financial institution;

More *generalised systemic problems* where interventions may be required across the system.

Part 2: Analyses the inter-institutional procedures for cooperation and decision making in the management and resolution of a financial crisis as they currently stand and makes a series of recommendations for the future.

This Part describes in broad terms the parameters of the existing decision-making process in relation to the management and resolution of financial crises. It goes on to envision what elements an optimum financial crisis resolution decision-making process might look like.

It then undertakes a forensic examination of each node of the proposed new financial crisis management and resolution process under six generic headings:

- Objective
- Key Player
- Clarity of Role and Function of Key Player
- Efficacy of Systems and Processes
- Action Necessary to Remedy Perceived Deficiencies
- Action by Department of Finance

The examination of the decision-making process follows the strategic framework for financial management and resolution identified by Stanley Fischer of the IMF but ahs been adapted to Irish circumstances. The rest of this Chapter is accordingly structured on the following basis.

Stages of Financial Crisis Management and Resolution	***No. of Discrete Decision Points at each Stage***
Financial Crisis Identification and Confirmation Stage	6
Stabilisation Stage: Developing the Financial Stability Programme – Tier One Decisions	11
Confidence Building Stage: Public Relations and Communication Strategy	7
Restructuring Implementation Stage – Tier Two Decisions	10
Final Recovery Stage	5
Total Number of Critical Decision Points	39

The focus is on building pre-programmed supports to support optimum decision-making at the time of crisis. The Review therefore will be precise and specific about what structures, systems and processes should be in place but will simultaneously preserve maximum flexibility in relation to the response mechanisms chosen at the time of financial crisis.

<u>This Part concludes that t</u>he work to date also suggests that

- certain administrative arrangements and decision-making structures should now be put in place;
- legislative powers should be clarified in order to facilitate the optimum decision-making;
- necessary powers to allow the Minister to act should be put beyond doubt in the form of specific legislation to allow the Minister or his agents to provide liquidity, grants; guarantees; take equity participations or to acquire an insolvent banking institution where the threat to financial stability would warrant such action;

- National strategy should be informed by the developments at European Union Level.

Part 3: Contains a series of appendices containing extracts from the extensive research material and background data consulted as part of the Review.

Cultural and Strategic Considerations

It is not surprising that a review of this nature should throw up some issue where tradition, precedents and culturally-driven attitudes may seek single purpose solutions to multidimensional problems. A number of such issues have arisen in this Review and are discussed briefly in the following paragraphs. A more thorough-going analysis of the value of certain constructs is provided in the body of the Review itself. Our view is that the nature of the game has changed profoundly and multifaceted and complex responses will be required for the future.

Secondly, the evolution and development of the financial services legislation in Ireland has only in recent years been subject to sustained and strategic reform. This review identifies a further need to clarity in legislation the boundary of the role, responsibilities and accountability of the Minister for Finance in the financial services sector.

A number of brief observations are provided on such topics in the following paragraphs

1. Underlying Assumptions in Black Book

- A number of underlying assumptions in the Black Book are worthy of note. These are;

  i. The time constraints placed on the key decisions makers in the Department are set in terms of hours not days or weeks! This is a function of the rate of technological development in the markets.

  ii. The Black Book is based on the assumption that, at least the two major players in the Irish retail banking market are too big to fail. Other second tier organisations will be stress tested by the CBFSAI to determine whether they are too big to fail.

  iii. The expectation on the part of the CBFSAI is that the Minister for Finance will commit substantial (but unquantified) funding to the ailing enterprise on the basis of incomplete information (also perhaps presented in a self-serving way) presented by the Chairman and CEO of the ailing bank.

iv. CBFSAI envisage that an immediate commitment of public money will be made in the form of a letter of comfort or State guarantee issued by the Minster for Finance within hours of the alert of the impending crisis. At which point no clear analysis of the situation is available.

v. There are no suggestions as to how and to what degree the private sector should be involved in funding the resolution of any financial crisis.

- The Review examines the relevance and sustainability of these assumptions in the light of prevailing regulatory, prudential, governance, accountability and parliamentary practices in the course of its analysis of optimum response mechanisms. A number of preliminary comments are however appropriate

i. If the underlying assumption is that the two big players in the Irish market are TBTF is left unchallenged it will mean that over 80% of the Irish Bank Sector is deemed to big to fail. Ab initio, this raises issues of concentration and fundamental questions about the efficacy of competition policy as it applies to the Banking sector. Issues of equity also arise as to why 'uninsured depositors' with smaller entities not of systemic importance should not be protected.

ii. As CBFSAI is statutorily responsible for the maintenance of the payments system, the health of which would be a critical part of any decision matrix, it would be critical to ensure that the CBFSAI and IFSRA are put into the position of having to take the lead role in regard to advising the Minister in regard to the crisis and to clearly recommend a way out of the impasse.

2. *Constructive Ambiguity*

Considerable time and attention is devoted in the Review to the concept of constructive ambiguity, mainly because, it is not a readily understood concept. Intuitively, ambiguity on its own could hardly be described as being constructive. Secondly, constructive ambiguity is a bedrock concept, the acceptance or rejection of which has profound implications for the direction of policy. Thirdly, on forensic examination, the concept has been found to have two apparently contradictory effects. It may be relevant in the context of the CBFSAI's posture in regard to the provision of liquidity assistance in any set of prevailing circumstances. The Review, however, demonstrates that its application to the question of establishing structures, systems and procedures to deal with any future financial crisis may be contrary to the national interest and damaging to the long-term health of the banking system.

3. *Clarity of Strategic Role of Minister in relation to Financial Services*

- An unanticipated outcome of the Review is that there is no specific role specified in the financial services legislation for the Minster for Finance in regard to financial stability. The Ministers and Secretaries Act, 1924, is also silent on the issue. This Review will recommend that this deficiency be made good.

- What is even more curious is that neither the legislative codes for financial services or the Ministers nor Secretaries Acts *specifies the role of the Minister for Finance in relation to financial services generally*. It is not apparent that any other body or code of legislation does either.

- A part explanation for this state of affairs may be found in the legislative drafting conventions that have to date tended only to specify the Minister's role, functions, powers and responsibility within the confines of specific pieces of legislation. The strategic and general role, function and powers of the Minister in relation to financial services overall seem to have got lost in the specificity of industry and sectoral codes of legislation.

- It is suggested that the point is of some significance and that his responsibilities in relation to domestic and international financial services be unambiguously established.

Stress Test / Pilot Project

As indicated earlier, the European Union requires member State governments to undertake a pilot study to stress test the ebullience of their financial crisis management and resolution systems. In exercise of this requirement, the BFI approach was to conduct a review of the structures, systems and procedures that can currently be relied upon for this purpose. At an early stage it became apparent that a number of shortcomings were evident at the structural, systemic and decision-making levels. These lacunae have now been confirmed to be of such significance as to render any procedural pilot exercise of dubious value. It is recommended that the pilot exercise would have much more meaning and relevance when policy decisions have been taken in relation to the structural, systemic and procedural issues identified in this Review. It may be purely coincidence that the date for the EU pilot test has also been deferred until spring 2006.

Motivation

The particular in-depth approach to this project was motivated by a number of primary influences. The first was the statement by the former Secretary General of the Department of Enterprise Trade and Employment at the Departmental Conference on the importance of using the Regulatory Regime as a means of improving competitiveness. Second was the endorsement of this concept by the Senior Management Team at the Departmental Conference. Thirdly the Secretary General at the Division's meeting with the MAC stressed, in particular, the importance of the competitiveness indicator as we embarked on modernising the regulatory regime for financial services. Furthermore the Secretary General has repeatedly stressed the need to conduct and assessments of the major risks facing the Department.

The Recommendations

The recommendations in this Review if implemented are consistent with the advancement of Ireland further up the International Capital Market Development Indices. Secondly they will help minimise the financial costs of managing and resolving financial crises to the private and the public sector. They will finally help ameliorate the potential economic fallout from such an event.

Mr. Paul O'Brien, now with OPW and Mr. Declan Cahill provided valuable assistance in completing this project.

Finbarr Kelly,
BFI Division,
20 May, 2005

29 April, 2005

MEMORANDUM OF UNDERSTANDING ON CO-OPERATION BETWEEN THE BANKING SUPERVISORS, CENTRAL BANKS AND FINANCE MINISTRIES OF THE EUROPEAN UNION IN FINANCIAL CRISIS SITUATIONS

Introduction

The agreement of the Parties leading to this Memorandum is based on the following considerations:

(1) The integration of financial markets and market infrastructures in the European Union (EU), together with the growing number of large and complex financial institutions, increases the scope for cross-border contagion and thus the likelihood of a systemic crisis affecting more than one Member State. In this context, it is important to have in place practical arrangements concerning co-operation in cross-border crisis situations at the EU level among the authorities potentially involved in preserving financial stability.

(2) The framework defined in this Memorandum will apply to crises which may have a potential for both cross-border and systemic impact affecting individual credit institutions, banking groups or banking components of financial groups, as well as to other possible systemic disturbances with cross-border implications, including those affecting payment systems or other market infrastructures.

(3) Co-operation between banking supervisors, central banks and Finance Ministries will take place in accordance with, and without prejudice to, their responsibilities under national and Community legislation, as well as the Treaty. In particular, in the context of this Memorandum, supervisory responsibilities should be interpreted in accordance with the applicable Community directives, including the role of consolidated supervision. Central banks' responsibilities should be interpreted with regard to their capacity as monetary authorities and overseers of payment systems, as well as their overall responsibility for contributing to the stability of the financial system as a whole. Finance Ministries' responsibilities should be interpreted with regard to their public accountability for the management and resolution of systemic crises.

(4) The Parties emphasise that this Memorandum is designed to facilitate the management of cross-border systemic crises with a view to safeguarding the functions of the financial system. The potential systemic implications of a crisis affecting a financial institution may require the involvement of banking supervisors, central banks and, in certain circumstances, of Finance Ministries. Such involvement should not be construed as representing an exception to (i) the principle of the firm's owners'/shareholders' primary financial responsibility, (ii) the need for creditor vigilance, as well as to (iii) possible market-led solutions to solve a crisis situation in individual institutions.

(5) Information-sharing between banking supervisors, central banks and Finance Ministries, will take place in the context of this Memorandum, on the basis of existing practices and arrangements and subject to the applicable conditions for the transmission of confidential information set out in national and Community legislation. In particular, information-sharing is limited to those authorities whose policy-making functions may be affected by the crisis situation.

(6) This Memorandum is seen by the Parties as an appropriate instrument for setting forth arrangements aimed at promoting co-operation between them in crisis or potential crisis situations without overriding their respective institutional responsibilities or restricting their capacity for independent and timely decision-making in their respective fields of competence, notably with regard to the conduct of day-to-day central banking and supervisory tasks. In particular, the evaluation of the possible systemic importance of a crisis situation, which may be required to be transmitted to Finance Ministries in accordance with this Memorandum, remains within the scope of the autonomy of banking supervisors and central banks.

(7) The Parties acknowledge that crisis situations may in practice involve a wider range of authorities and respective functions, including other financial supervisory authorities, deposit insurance schemes and competition policy authorities. This Memorandum is without prejudice to further co-operation arrangements involving a wider range of authorities and may be reviewed accordingly. The Parties also acknowledge that certain crises may require international co-operation with authorities whose jurisdiction lies outside the EU. However, such co-operation is beyond the scope of this Memorandum.

(8) This Memorandum complements, and is without prejudice to, other present and future arrangements on co-operation between responsible authorities, particularly banking supervisors and central banks. In this context, the Parties will aim to ensure that co-operation and information-sharing in crisis situations take place in a manner consistent with the provisions and objectives of any other existing arrangements.

THE PARTIES TO THIS MEMORANDUM OF UNDERSTANDING AGREE TO THE FOLLOWING:

1. Objective of the Memorandum

The objective of the Memorandum is, building on the existing national and EU arrangements, to support and promote co-operation in crisis situations between banking supervisors, central banks and Finance Ministries through appropriate procedures for sharing information, views and assessments, in order to facilitate the pursuance of their respective policy functions and preserve the overall stability of the financial system of individual Member States and of the EU as a whole. In particular, these authorities should be in a position, if needed, to engage in informed discussions amongst themselves at the cross-border level in the case of crisis situations affecting the financial system of more than one Member State or the EU as a whole.

2. The scope of co-operation in crisis situations

2.1 Banking supervisors, central banks and Finance Ministries will co-operate at the national and cross-border levels in accordance with the framework set out in this Memorandum. Co-operation will primarily involve the exchange of information, views and assessments among the Parties.

2.2 This Memorandum shall apply to crises with both potential cross-border and systemic implications. In particular, the reference to "crisis" throughout this Memorandum shall include the following features of potential cross-border and systemic shocks:

(i) Crises affecting individual credit institutions;

(ii) Crises affecting banking groups or the banking components of financial groups; or

(iii) Other systemic disturbances, including those affecting payment systems, other market infrastructures or financial markets;

which may warrant the involvement of Finance Ministries.

2.3 The co-operation procedures specified in this Memorandum may also be activated, at the discretion of the Parties involved, to exceptional events likely to lead to public concern and seriously affect the financial systems of more than one Member State.

3. Responsibilities in crisis situations

3.1 Efficient co-operation among authorities is expected to take place on the basis of the existing institutional and legal framework for financial stability in Member States, as well as the applicable Community legislation, fully respecting the roles and responsibilities of banking supervisors, central banks and Finance Ministries.

3.2 The co-operation between banking supervisors, central banks and Finance Ministries will be intended to enable each authority to fulfil their respective tasks and responsibilities, in accordance with Community and national legislation.

4. Activation of co-operation procedures

4.1 A crisis situation referred to in this document is not definable ex ante. It remains within the discretion of the responsible banking supervisors and/or the central banks to determine whether a crisis is emerging or developing for the purposes of this Memorandum. In the case of a potential crisis situation, co-operation procedures are expected to be activated in a timely manner.

4.2 Any of the Parties may transmit or request relevant information if a potential crisis situation appears to be developing, and joint discussions may be initiated at the request of any of the Parties.

5. Procedures for the sharing of information

5.1 Subject to the conditions set out in this Memorandum, the banking supervisors or the central banks that have access to information related to a potential crisis situation will provide their respective Finance Ministries with information regarding material developments or concerns including where possible, an assessment of potential systemic and cross-border implications, which may require their involvement.

5.2 Subject to the conditions set out in this Memorandum, the Finance Ministry of each Member State will provide the respective banking supervisor and central bank with any relevant information on the potential crisis situations that may be received from other entities, particularly Finance Ministries from other Member States.

5.3 The concrete items of information to be shared between the Parties may include views and qualitative assessments and, where relevant, specific information on, such as:

(i) Potential systemic implications for the domestic financial system; where possible, consideration should also be given to the systemic impact on other Member States' financial systems as well as on the EU's financial markets as a whole;

(ii) Where possible, on specific channels of contagion of the crisis to institutions, markets and market infrastructures;

(iii) Where possible, consideration of other relevant economic implications of the crisis situation;

(iv) Where possible, any constraints to the implementation of policy measures;

(v) Updates of relevant developments and related information.

5.4 The specific information needs, and the authorities to be contacted, shall be determined by the Parties in light of the particular features of the potential crisis. In particular, information shall only be shared among those Parties of each Member State whose policy-making functions may be affected by the crisis situation in view of the likely effects of the crisis on institutions, markets or market infrastructures within the competence of those authorities.

5.5 The Parties undertake to provide each other, where relevant and subject to Community and national law, and in accordance with the procedure set out in Section 7.1, with advance notice of any policy measures that may be undertaken in the context of the crisis situation, without prejudice to urgent decision-making by the responsible Parties.

5.6 The Parties involved in a crisis situation will, to the extent possible, co-ordinate jointly any statement to the public by discussing the appropriate content of such communication beforehand.

6. Co-operation at the national level

6.1 At the national level, the Parties will co-operate and share information in accordance with existing laws, institutional arrangements and procedures.

6.2 In order to cope with the situations described under Section 2, it is desirable that appropriate arrangements and procedures exist at the national level on mutual co-operation and exchange of information on common general issues related to financial stability among at least banking supervisors, central banks and Finance Ministries. Although the details of such arrangements are at the discretion of the Member States the arrangements should contribute to facilitating the operation of this Memorandum as well as setting out contingency plans in case of a potential national or cross border systemic crisis.

7. Co-operation at the cross-border level

7.1 At the cross-border level, banking supervisors, central banks and Finance Ministries, as a rule, will correspond with their respective counterparts in other Member States. At the discretion of any of the Parties, information may however be transmitted directly at the cross-border level between different types of authorities with concurrent transmission to the relevant counterpart authorities of the relevant Member State(s).

7.2 A crisis affecting more than one Member State may warrant multilateral co-operation among the Parties involved. In particular, measures in potential systemic and cross-border crises may need to be based on a common understanding as well as on assessments of the situation shared among the relevant authorities in several Member States. In such situations, those authorities involved or likely to be involved will decide on the most appropriate means for communication, information-sharing and co-operation among them.

7.3 In cases where wider multilateral co-operation among the Parties needs to be activated, such as in major disturbances that may affect the EU as a whole or several Member States, existing EU-committees may provide a platform for exchange of information, views and assessments.

8. Confidentiality

8.1 Any information exchanged and received by virtue of the application of the provisions of this Memorandum is subject to conditions of confidentiality and professional secrecy as provided in Community and national legislation.

8.2 The Parties will maintain, vis-à-vis third parties, the confidentiality of any request for information made under this Memorandum, the contents of such requests, the information received, and the matters arising in the course of co-operation without prejudice to relevant Community and national provisions.

8.3 The Parties will ensure that all persons dealing with, or having access to, such information are bound by the obligation of professional secrecy.

9. Crisis arrangements and contingency planning

9.1 The Parties will endeavour to develop, as well as to test and update on a regular basis, at the national and EU levels, contingency arrangements for managing crisis situations as well as conduct stress-testing and simulation exercises. The primary goal of such exercises would be to enhance the preparedness of authorities for handling potential crisis situations with cross-border systemic implications. The Parties may wish to share, utilising the existing EU committees, the methods and assumptions used in organising and conducting such stress-testing at national level.

9.2 As part of contingency arrangements, the Parties will organise emergency contacts lists at the national and EU levels including the indication of contact points, other public and private bodies that could be involved in a crisis situation, relevant sources of information, as well as all other means which could be regarded as necessary for the effective management of a crisis.

10. Further development of co-operation arrangements

10.1 The principles of co-operation provided in this Memorandum may also be implemented on a domestic or bilateral/multilateral basis by the Parties in accordance with their specific needs involving individual institutions, specific banking groups or the banking components of financial groups.

10.2 The Parties may, by common consent, invite other sectoral supervisory authorities and deposit insurance schemes of the Member States as well as Central Banks, supervisory authorities and Finance Ministries of the Contracting Parties of the European Economic Area to become parties to this Memorandum.

10.3 The Parties to this Memorandum will review this Memorandum periodically and consider necessary amendments within three years, if warranted in the light of experience or relevant developments – of its entry into effect.

11. Nature of the Memorandum

11.1 As the provisions of this Memorandum are not legally binding on the Parties, they may not give rise to any legal claim on behalf of any Party or third parties in the course of their practical implementation.

11.2 The provisions of the MoU do not prejudge or assume any particular decisions or remedies to be taken in crisis situations nor do they imply any change to or commitment to change existing national legislation.

12. Entry into effect

This Memorandum shall enter into effect on 1 July 2005.

Annexes:

1. Description of the roles and tasks of the Economic and Financial Committee (Financial Stability Table), the ESCB Banking Supervision Committee, Committee of European Banking Supervisors and Financial Services Committee.
2. List of signatories.

ITEMS DEBATED

THE ECONOMIC SITUATION AND FINANCIAL STABILITY

The Council held an exchange of views on the economic situation and financial stability, on the basis of a report from the economic and financial committee and further to discussion by ministers at an informal meeting in Porto on 14 and 15 September.

The Council agreed on a work programme, which runs until the end of 2008, aimed at reviewing, along with the EU's international partners, how to further improve transparency, valuation process and risk management in financial markets.

DIALOGUE WITH THIRD COUNTRIES ON ECONOMIC ISSUES

The Council was briefed by the Commission on dialogue with the EU's main international partners as regards macroeconomic, financial and regulatory issues.

It held an exchange of views on developments in strategic dialogues aimed at enhancing convergence, cooperation and mutual understanding between international partners and contributing to the facilitation of market access and to promoting macroeconomic stability.

The presidency suggested that the Council be regularly updated on these dialogues.

FINANCIAL SERVICES

Clearing and settlement - *Council conclusions*

The Council adopted the following conclusions, following on from discussions by ministers at an informal meeting in Porto on 14 and 15 September:

"The reality of a single European securities market is not compatible with a fragmented European post-trading sector. Achieving competitive, efficient and safe pan-European post trading arrangements is becoming more and more critical.

Efforts have been made to achieve greater efficiency, integration and safety in post-trading arrangements in the EU, both by the private and public sectors, namely by means of: (i) the industry Code of Conduct for clearing and settlement signed in November 2006; (ii) the European Central Bank's initiative to set up TARGET2-Securities; (iii) the work on dismantling the fiscal and legal barriers to securities market integration (Giovannini barriers); and (iv) the efforts of the European System of Central Banks (ESCB) and the Committee of European Securities Regulators (CESR) to promote the safety and soundness of European post-trading arrangements such as by means of standards.

In November last year, the ECOFIN Council agreed to carry out a set of strategic discussions in autumn 2007 and spring 2008 to review the state of play of the aforementioned initiatives, with a view to considering further policy action necessary so as to ensure progress in all key areas.

On the basis of the report presented in July by the European Commission – "Improving the Efficiency, Integration, and Safety and Soundness of Cross-border Post-trading Arrangements in Europe" – and following the exchange of views at the Informal ECOFIN meeting in Porto, the Council:

- AGREES that the continuous fragmentation of the European securities post-trading sector leads to unnecessarily high costs, especially for cross-border securities transactions in the EU, which constitutes a considerable competitive disadvantage for European capital markets.

- WELCOMES the progress already achieved in certain key areas while stressing the need for further substantial progress.

With regard to the implementation of the Code of Conduct, the Council:

– WELCOMES the entry into force of the areas relating to price transparency and to access and interoperability segments, and the positive results achieved so far, and emphasises that more progress is needed on price comparability.

– LOOKS FORWARD to the entry into force of the third area of the Code – service unbundling and accounting separation by the end of 2007 – and stresses the need to continue monitoring closely the implementation of the Code of Conduct.

In respect of TARGET2-Securities, the Council:

– WELCOMES the fact that the ECB is proceeding along the lines of the Council conclusions of February 2007 and conducting a public consultation process on the general principles, nature and scope of TARGET2-Securities. Further decisions on the development phase can be expected in spring 2008 and ECOFIN Ministers will be kept informed before any further decisions are taken.

Concerning the removal of legal and fiscal barriers identified in the "Giovannini Report", the Council:

– AGREES that their removal is a key priority and considers that concrete actions and a timeframe should be proposed promptly by the Commission on the basis of the work of the advisory groups taking into account the views and responsibilities of the Member States; and the Financial Services Committee is INVITED to provide guidance to ensure progress and to monitor development.

As to the work on ESCB/CESR "Standards for Securities Clearing and Settlement in the EU", the Council:

– RECOGNISES that the investor protection and prudential safety of the post-trading sector, including its risk-management aspects, are important issues to be discussed and that concrete action, including for example by agreeing on the standards or regulatory measures, should be considered as a complement for the Code of Conduct on risks and financial stability.

– REQUIRES the FSC to deepen its work on the scope, legal basis and contents of the standards giving due consideration to the importance of ensuring a level playing field; and together with the Commission propose ways forward on this subject to be submitted to the Council in early spring 2008.

The various ongoing initiatives should proceed in a coherent manner, not in isolation. All the measures mentioned above, if implemented well, will contribute to the creation of a far more efficient European securities market infrastructure."

EU arrangements for financial stability - *Council conclusions*

The Council adopted the following conclusions following on from discussions by ministers at an informal meeting in Porto on 14 and 15 September:

"Following the work priorities established by the ECOFIN Council of October 2006 and the discussion at the informal meeting of EU Finance Ministers and Central Bank Governors in Porto in September 2007, the Council AGREED to take further steps, at the EU and national level, to develop the arrangements for cross-border financial stability within the EU. These steps are based on recommendations from the Economic and Financial Committee and take into account the state of financial integration in the EU and existing stability arrangements. The Council AGREES that further actions should be taken to ensure that arrangements for financial stability are in line with evolving financial markets and that the EU obtains the full benefits of financial integration. In particular, the Council

RECOGNISES that:

- integration contributes positively to overall performance of the EU financial sector and promotes financial stability; in this context, the number of large cross-border banking groups has substantially increased, which improves the efficiency of financial services, including for businesses and consumers across the EU;

- the EU framework for prudential supervision and crisis management and resolution must allow a quick response to cross-border systemic financial crises and their implications;

- financial stability in the EU is a common concern for all Member States and must be safeguarded on the basis of close co-operation; and

- preparation in advance is necessary for an effective safeguarding of financial stability across borders, while allowing for flexibility to deal with specific circumstances.

AGREES on common principles that will be the basis for co-operation among national authorities in preserving financial stability within the EU. These principles, set out in Annex I, should be respected in the management of any cross-border financial crisis with potential systemic implications. They constitute a consistent and sound basis for responding to any financial crisis situations in the EU, specifying the overarching considerations for cross-border cooperation, taking into account that quick actions may be needed to safeguard financial stability.

INVITES, in order to enhance procedures for co-operation and preparedness of authorities in the EU, the Economic and Financial Committee to prepare for spring 2008, an extended Memorandum of Understanding (MoU) that will build on the EU MoU signed in 2005 between Heads of Competent Banking Supervisory Authorities, Central Banks Governors and Finance Ministers in the EU. The new MoU will include:

- the common principles;
- a common analytical framework for the assessment of systemic implications of a potential crisis to ensure the use of common terminology in assessing the systemic implications of a cross-border financial crisis by all relevant authorities; and to enhance the availability of timely assessments among authorities that will facilitate the decision-making in a crisis situation. The EU Central Banks, Supervisory Authorities and Finance Ministries are INVITED to use this framework by the end of 2008; and
- common practical guidelines for crisis management to reflect a common understanding of the steps and procedures that need to be taken in a cross-border crisis situation.

ENCOURAGES authorities in different Member States that share financial stability concerns to start developing, as soon as possible, voluntary cooperation agreements consistent with the extended EU wide MoU and building on cross-border supervisory arrangements for crisis prevention. These agreements would focus on the principles and procedures in detail - taking into account particular needs of crisis management in a specific cross-border context. To facilitate the conclusion of these agreements, the Council INVITES the Economic and Financial Committee to develop concrete examples by spring 2008.

WELCOMES the progress made by the EU Member States with their national arrangements for financial stability, in particular that *Domestic Standing Groups* have been put in place in most EU Member States. These groups bring together competent Supervisory Authorities, the National Central Banks and the representatives from relevant Ministries within a Member State for stability and crisis management purposes to enhance preparedness of authorities through the exchange of information, development of tools and also by conducting crisis simulation exercises. The Council INVITES all Member States to develop such Domestic Standing Groups.

RECOGNISES the need to facilitate cooperation and information exchange among authorities; and the need to enhance the availability of the tools that are necessary to preserve financial stability in Member States and to ensure their functioning across-border between relevant parties. To this end, the Commission is INVITED, in close co-operation with Member States, to examine possible enhancements, and where necessary propose regulatory changes as follows to:

– clarify the nature and extent of the legal obligations for Supervisory Authorities Central Banks and Finance Ministries to exchange information and to cooperate and in this context: increase information rights and *involvement of host countries*; clarify the role of *consolidating supervisors* and facilitate the timely involvement of relevant parties in a crisis situation; and consider including in the *mandates of national supervisors*, a task to cooperate within the EU and to take into account the financial stability concerns in all Member States;

– analyse the feasibility of reducing barriers to cross-border transfer of assets while defining appropriate safeguards for entities transferring the assets; and analyse the feasibility of revising rules for the winding-up of banking groups to include joint *insolvency proceedings* for cross-border groups while providing sufficient safeguards to all stakeholders of the group or its part being reorganised or wound-up; and

– improve interoperability of *Deposit Guarantee Schemes (DGS)*, by removing the inconveniences in the current arrangements, and clarify the practical implications of DGS to absorb and share any financial burdens.

3

INVITES the Commission, without prejudice to its assessment on a case by case basis and respecting Commission competences, working together with Member States, to endeavour to clarify when a major banking crisis could be considered by the Commission such as to provoke a 'serious disturbance of the economy' within the meaning of Article 87(3)(b) of the EC Treaty and state aid rules; and INVITES the Commission to consider streamlining procedures focusing on how state aid enquiries under such critical circumstances can be treated rapidly.

INVITES the Economic and Financial Committee and the Financial Services Committee to monitor and report regularly to EU Finance Ministers on the progress in all the above areas, as reflected in a strategic roadmap presented in annex 2. The EFC will test all the elements to be introduced in an EU wide crisis simulation exercise in spring 2009 and report to ECOFIN Ministers on its conclusions in autumn 2009.

LOOKS FORWARD to the enhancement of the Lamfalussy framework in the context of its forthcoming review in December 2007, on the basis of the reports by the Inter-Institutional Monitoring Committee, the Commission and the Financial Services Committee, including on financial supervision in the EU. In this context, the above conclusions will be taken into account so as to ensure coherence between the arrangements for crisis prevention and crisis management.

Annex I: Common Principles for cross-border financial crisis management

Member States agree on a set of common principles to be followed in the management of any cross-border financial crisis, which involves at least one banking group which (i) has substantial cross-border activities and (ii) is facing severe problems which are expected to trigger systemic effects in at least one Member State; and (iii) is assessed to be at risk of becoming insolvent. The common principles are the following:

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

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

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

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

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

6. Arrangements for crisis management and crisis resolution will be consistent with the arrangements for supervision and crisis prevention. This consistency particularly refers to the division of responsibilities between authorities and the coordinating role of home country supervisory authorities.

7. Full participation in management and resolution of a crisis will be ensured at an early stage for those Member States that may be affected through individual institutions or infrastructures, taking into account that quick actions may be needed to solve the crisis.

8. Policy actions in the context of crisis management will preserve a level playing field. Especially, any public intervention must comply with EU competition and state-aid rules.

9. The global dimension will be taken into account in financial stability arrangements whenever necessary. Authorities from third countries will be involved where appropriate.

Annex II: Strategic Roadmap for strengthening EU arrangements for financial stability

1. Procedures and principles to enhance co-operation and preparedness

- October 2007: adoption by EU Finance Ministers and Central Banks Governors of common principles for cross-border crisis management with the objective to have the common basis for financial crisis management between relevant authorities in the EU.

- End 2007: Member States to decide whether to include an EU-dimension in the national mandates of supervisory authorities, i.e. a requirement to cooperate and to take into account financial stability concerns in all Member States (to be recalled in the context of the 'Lamfalussy' review).

- Member States are encouraged to develop and sign specific 'voluntary co-operation agreements' between authorities in different Members States as soon as possible; and the Economic and Financial Committee will provide examples of such agreements by the spring 2008.

- Spring 2008: EU Supervisory Authorities, Finance Ministries and Central Banks to sign an extended EU wide MoU, which will be built on the 2005 MoU and will include common principles on crisis management including on the sharing of fiscal burden; and a common analytical framework. An annex will include practical guidelines for crisis management.

- End of 2008: authorities in Member States will use the common analytical framework for assessing a cross-border financial crisis.

– 2007-2009: the Commission to propose ways to clarify cooperation obligations including possible amendments to EU-banking legislation, especially to: clarify the existing obligations for Supervisory Authorities, Central Banks and Finance Ministers to exchange information and to cooperate in a crisis situation; increase the information rights and involvement of host countries; clarify the role of the consolidating supervisors and facilitate the timely involvement of relevant parties in a crisis situation; and examine whether, to this end, legislative changes are necessary, including to reinforce the legal requirements for supervisory collaboration and information sharing. Progress report by the Commission to the EFC by the end of 2007. Commission proposal end 2008; and adoption by EP/Council by the end of 2009.

– 2009: the Economic and Financial Committee to conduct an EU wide crisis simulation exercise in spring 2009 to test the proposed arrangements and to report to ECOFIN Ministers on its conclusions in autumn 2009.

2. Review the tools for crisis prevention, management and resolution

– 2008: the Financial Services Committee and the Commission to identify specific obstacles to use of the tools in cross-border situations and propose changes, to ensure the availability of relevant tools at the national level and the functionality of tools for crisis management and resolution taking into account the cross-border dimension.

– 2008: the Commission and Member States shall work towards clarifying when a banking crisis could be considered by the Commission as "*a serious disturbance for the economy*" (under the Treaty and State aid rules) and the Commission to consider streamlining procedures focusing on how State aid enquiries under critical circumstances can be treated rapidly.

– 2007-2009: the Commission to assess the possible extension of the scope of the present EU-Directive on winding up of credit institutions to include insolvent subsidiaries with the objective to increase the efficiency, the optimal reorganisation and winding up of cross border banking groups taking due consideration of the interests of all stakeholders concerned. The Commission to launch a public consultation October 2007; legal study of obstacles mid 2008; and release a Commission Green Paper by end 2008.

– 2007-2009: work started in spring 2007 to be continued by the Commission with the objective to clarify EU Deposit Guarantee Schemes Directive, especially: practical agreement and clarification of the scope of the Directive and tasks of DGS, 'topping-up', information exchange between schemes, reducing pay-out delays and improving depositor information. Deposit Guarantee Schemes and relevant authorities in Member States will be involved. Final results are expected by March 2009.

– 2007-2009: alongside the review of the winding up Directive followed by Commission proposal mid-2009, the Commission to perform a feasibility study on reducing barriers for cross-border asset transferability while introducing appropriate safeguards within banking, insolvency and company law, taking into account that the reallocation of assets in a crisis affects the ability of stakeholders in different legal entities to pursue claims. The overall objective is to reinforce the primacy of private solutions, avoid counter-productive ring-fencing of assets, and facilitate a smooth management of a crisis. "

Follow up to Crisis Simulation Exercise 2007[1]

Introduction

The following note represents a summary of the feedback from the players of the Crisis Simulation Exercise (CSE) held on the 17th of December. The exercise consisted of representatives from both the CBFSAI and the Department of Finance.

Plot Outline

The plot for the crisis simulation was based round the likely default of a large commercial property loan in Ireland. The default of the commercial property loan would have implications for Alpha bank both in terms of the quality of the loan book but also the future income stream of Alpha bank. Alpha bank was modelled on an existing Irish credit institution.

While the plot, the characters and the institutions were contrived the exercise was designed to reflect one possible scenario which could develop. The fictional financial institution and system was designed to reflect the features of the Irish financial system

Purpose of the Crisis Simulation Exercise

The aim of the exercise was to test the procedures put in place by both the CBFSAI and the Department of Finance. These included an assessment of our crisis management procedures, especially:

1. The co-ordination between the three parties
2. The Functioning of the CSG in terms of an advisory forum on crisis management and the roles assigned to CSG members
3. Adequacy of, and assessment of, information that is critical to crisis management
4. Testing the use of materials in the new Black Book e.g., Crisis Management Procedures, System Impact Assessment and the communications Strategy

[1] Compiled by Gordon Barham, FSD

Lessons learned from the Crisis simulation Exercise

Based on the criteria listed above, the following section summarises the general points offered in the feedback forms. An annex at the end of this note provides further information on the feedback broken down into CB, FR and DoF Responses.

1. **Communications channels** were highlighted as an area that requires future work. The concern surrounds the communication between DSG members as well as the role of press offices in communicating with the public.

   The DoF was concerned about the extent to which "CB" represented "FR" position in a crisis and vice versa, risk of second guessing by Department of 'political' objectives and potential for conflict of objectives that would arise between all parties

   Feedback from both the CB and FR also highlighted a need for increased communication and flow of information with the DoF

In order to ensure a balanced view it was suggested that a representative from both the CB and FR be present during meetings with the DoF.

The flow of information could also be enhanced if key information that the DoF would require was identified in advance insofar as possible. This could include information on the breakdown of deposits. It may be necessary to nominate a member of the CSG to be responsible for collating this information. However, it is worth considering the logistics of this step in light of any confidentially agreements held between the CBFSAI and regulated institutions

Focusing on the role of outside communication it might be useful to prepare templates of press releases that the DSG members could call upon in a crisis situation

2. The number of participants involved in the CSG presented **logistical issues** such as the sharing of information among the members. This led to a situation where individuals were talking among themselves rather than the CSG interacting as a single group. This led to information asymmetries and hampered the ability of the group to form a coherent view.

The suggestion is to streamline the CSG with a structure similar to the CBFSAI organisation. Each area – Prudential, Operations, Financial Stability/Economics etc. would take responsibility for their area of analysis. Each area would be *responsible for offering their view of the systemic nature of the affected institution(s). The head of Financial Stability would be responsible for collating these high level views only.*

3. **Prioritisation of Information** It was felt that the members of the Crisis Steering Group (CSG) were required to process too much information in a relatively short period of time. Given the flow of information, participants found it difficult to assimilate information and in turn it was difficult to form an overall picture of the situation.

   More attention needs to be paid to operational deadlines that would be faced during an actual crisis. These include deadlines for the Stock Exchange, payments system and Collateral transfer.

   A combination of the above points meant that it was not possible to carryout a systemic impact assessment

It may be useful to prepare a list of key data sets that participants feel are important for evaluating a crisis. This list could also include a template of how this material should be presented to the relevant decision makers. This would allow decision makers to be more aware of what material is readily available, if available at all.

It might be useful to draw up a short (one-page) template in relation to the systemic impact assessment which would cover the key areas of concern. Each area would take responsibility for there own section of the systemic impact assessment. In this way the relevant sub-groups of the CSG could focus their analysis and briefing on the required assessment.

The above recommendations should reduce the issues of "too many voices" and allow the CSG to focus on the pertinent issues. The Red book should be revised in light of these concerns.

4. Based on the feedback provided by the players almost all indicated that they had read the **Red Book** prior to the crisis exercise. However, few indicated actually using the book during the course of the exercise. The most relevant parts indicated by the feedback forms were the contact lists, and the first three chapters (procedures for crisis management – summary, Systemic Impact Assessment – procedures and ELA procedures and Collateral Transfer Documentation)

Question: Were participants happy with the role of the Red Book in the exercise? In light of the feedback from the exercise does the DSG feel there are areas of the Red Book that need improving/reviewing?

5. The role of the **Deposit Guarantee Schemes** (DGS) needs to be looked at in more detail. It was felt that the decision to advise the DoF to guarantee all deposits was reached too quickly without looking at intermediate options and without sufficient thought given to the ultimate burden of responsibility.

There is ongoing work examining the policy issues surrounding DGS

Future Work on Crisis Management

Arsing from the exercise a number of areas have been highlighted by participants. These include:

- Further analysis into the interlinkages – interbank borrowing and lending positions – between institutions.
- Further analysis on the overseas operations of Irish banks and how they might be dealt with in a crisis. For example, would deposit assurance have to be extended to deposits at foreign branches of Irish banks – as in the Northern Rock case?
- Improve information and identify the key data required for dealing with a crisis
- Further work into the area of deposit guarantee schemes and deposit insurance.
- Examine the role of communication both internal and external further

Areas of Focus for Subsequent Crisis Simulations

Participants were asked to comment on areas of interest for future simulations. All three authorities highlighted the area of media relations and communication with the public. As already stated previously, further consideration is the need to coordinate a response and ensure that the correct message is conveyed to the public.

In addition to media relations some other areas suggested included:

- Circumstances when assurances, guarantees, commitments should be extended
- Examine if the necessary administrative arrangements/parameters including legal issues are in place. This may require advanced planning for each bank in advance
- More focus on specific roles played by individuals. Possible mini-exercises based on testing key aspects of certain roles.

In addition to the areas that need to be concentrated on in future exercises, participants offered feedback on the logistics of exercise. In general most consider that the CSE was conducted over too short a period and that future exercises should be conducted over a minimum of one day. This would allow participants to process the material more thoroughly. Based on the feedback it was felt that an actual crisis is unlikely to play out over the course of an afternoon.

A number of responses suggested a movement away from the paper-based format of this exercise, as it was too cumbersome. It has also been suggested that there should be greater involvement from the staff of relevant departments/authorities.

An exercise that is held over a longer period would greatly increase the workload required to prepare the necessary background material. However, the involvement of staff from the relevant department/authority would allow for a more realistic exercise. A dedicated person or team from each of the relevant departments/authorities could be involved throughout the planning process and implementation of the exercise would allow the material to be presented in a more realistic manner. The designated person(s) could also act as a point of contact in dealing with "players" queries during a CSE and allow for more interaction. This could help reduce/replace the paper-based format of the last game. However, it is worth considering, in reality, what level of involvement ordinary staff would have in a crisis.

The DSG is asked to review and discuss the feedback from the participants. From the discussion the follow-up steps can be agreed and crisis management procedures revised accordingly.

Annex: Extended Summary of CSE Feedback

Central Bank Feedback

General Comments

Overall, participants found the exercise to be worthwhile. In general the players found the plot to be realistic and found it topical. The main points of the Central Bank feed back are outlined below:

- A number of players indicated that the exercise was run over too short a period.
- The number of participants involved in the CSG presented logistical issues such as the sharing of information among the members. This led to a situation where individuals were talking among themselves rather than the CSG as a single group. This led to information asymmetries and hampered the ability of the group to form a coherent view.
- It was felt that the members of the Crisis Steering Group (CSG) were required to process too much information in a relatively short period of time. Given the flow of information, participants found it difficult to assimilate information and in turn it was difficult to form an overall picture of the situation.
- A combination of the above points meant that it was not possible to carryout a systemic impact assessment.
- The role of the Deposit Guarantee schemes needs to be looked at in more detail. It was felt that the decision to advise the DoF to guarantee all deposits was reached too quickly without looking at intermediate options and without sufficient thought given to the ultimate burden of responsibility.

Specific Comments

In terms of the comments based on how the exercise was played the following are points expressed by the Central Bank participants:

- An area which may not have received sufficient attention are timing issues through the course of the day such as closing time of payments and deadlines relating to the Stock Exchange.
- There is a need to separate theoretical/conceptual issues from operational issues. During a crisis the issues should relate to operational issues in light of informed discussion on the theoretical issues. Theoretical issues, such as moral hazard and deposit protection should be dealt with prior to a crisis.
- It was felt that there should have been greater communication with the DoF. It appeared that at certain stages Finance were out of the picture. The apparent lack of contact and up-to-date information may have hampered the ability of the DoF to come to a clear decision in light of the available information.
- When initially briefing the DoF it was felt there was a need to have a representative from both the CB and FR. This is in order to be able to answer any bank specific question Finance may have as well as to represent the views of the FR and support the view of the CB where necessary.
- The role of the press office was highlighted as an area where careful work needs to be conducted. Specifically, the role of press releases from the relevant public authorities.

Role of the Red Book

In terms of the usefulness of the Red Book most participants glanced at it prior to the exercise. The most useful part related to the logistics of the CSG such as organisation and contacts list. Participants indicated that in general they did not use the Red Book during the exercise.

Future work on Crisis Management

Arsing from the exercise a number of areas have been highlighted by the participants. These include:

- Further analysis into the interlinkages – interbank borrowing and lending positions – between institutions.

- Improve information and identify the key data required for dealing with a crisis
- Further work into the area of deposit guarantee schemes and deposit insurance.
- Further analysis on the overseas operations of Irish banks and how they might be dealt with in a crisis. For example, would deposit assurance have to be extended to deposits at foreign branches of Irish banks?
- In relation to preventive measures, should there be greater analysis of the sustainability of banks' business models. Should the risk weightings of different asset classes be reviewed more frequently?
- Clarify precise requirements from various areas during the course of a crisis e.g., 15/30 minute updates of payments balances/queues and movements in collateral.

Areas of Focus for subsequent Crisis Simulations

Areas identified by CB participants for greater focus in future exercises include:

- Circumstances when assurances, guarantees, commitments should be extended
- Content of any press statement
- Ensure administrative arrangements/parameters including legal issues are in place; this will not be properly done without planning for each bank in advance
- More focus on specific roles played by individuals

Financial Regulator Feedback

General Comments

The participants of the Financial Regulator found the exercise to be constructive, relevant and timely. The case study dealt with the important issues such as solvency and liquidity. It raised certain issues that need to be addressed and highlighted the pressure situation that participants would find themselves in a real crisis. The main points of the Financial Regulator feed back are outlined below:

- The number of participants involved in the CSG presented logistical issues such as the sharing of information among the members.
- The length of the exercise was too short. The decision process would have benefited had the exercise been played over a longer period.
- The assessment of the crisis was unclear as there was no systemic impact assessment carried out
- Insufficient contact between the Regulator and the Department of Finance

Specific Comments

- There may have been too much communication and information sharing at the expense of identifying the information critical for crisis management
- There was no apparent conflict of interest between the CB and FR although the reasons for this may need to be examined further to ensure it was not just a function of this being an exercise only
- The roles of particular individuals, as outlined in the Red Book, need to be clearly explained to ensure everyone is aware of their responsibilities and the responsibilities of others.
- There may be some value in having a whiteboard or similar device in the CSG's meeting room to record key information and have it visible to all participants
- Would be useful to look at final decision again in the cold light of day – check validity

Role of the Red Book

In general people looked at the Red Book prior to the exercise, specifically the first three chapters, but did not consult the Red Book during the exercise.

Future work on Crisis Management

- The co-ordination of decision making seemed to work well at senior CB&FR levels but we should consider the potential impact if the Board and Authority members were to become involved

- As outlined in Annex 2 of the Red Book, the Task Force on Crisis Management has identified key information required to perform an assessment of the systemic impact of a crisis. Some of this information is already gathered but may not be readily available or sufficiently up-to-date when a crisis occurs. One priority should be to review these information requirements and decide if institutions (or a small number of them) should be required to provide additional information on a regular basis or to be able to produce such information at short notice.

- The need for a set of predefined templates for information and a central repository for recording new information as it arrives.

- Agreement is needed on how the Deposit Guarantee Scheme will operate in a crisis and what communication should be provided to the public. This is already being examined in the Sub-Group.

- Our role in relation to crisis management for Irish branches and subsidiaries of foreign banks and foreign branches and subsidiaries of Irish banks needs to be clarified.

- We need to explore what measures/options are available to handle a crisis apart from ELA or Government guarantees.

- Focus on the channel of communications. What are we saying publicly, especially in the early stages when we are unsure about the state of the ailing bank and any Government guarantee. Secondly who will be saying it - Minister/CEO/Governor etc.?

Areas of Focus for subsequent Crisis Simulations

- Consider a change in the format of the exercise. Move away from a paper based approach. Consider other channels of communication. In a real crisis the most immediate information would be communicated by telephone, face-to-face meetings and email
- In reply to: future simulation exercises there needs to be involvement of the staff of the CSG in seeking out and distributing information.
- Ensure that, whatever format future exercises may take, there are sufficient handouts and information for all participants.
- Examine the role of communication both internal and external further

Department of Finance Feedback

General Comments & Future Work in Crisis Management

The exercise was very useful in highlighting the range of issues that can arise in the context of a crisis. It demonstrated that a lot of work is required by all parties both individually and collectively (in the context of the work of the DSG) to increase preparedness to an appropriate level for responding to a financial instability event. The areas require further work include:

- Availability/'flow' of information between public authorities
- Communication/level of contact between authorities
- Assessment/analysis of options from an early stage
- Extent to which "CB" represents "FR" position in a crisis and vice versa, risk of second guessing by Department of 'political' objectives and potential for conflict of objectives that would arise between all parties
- Utility/benefit of pre-prepared material
- Role/effectiveness of MoU for DSG
- Slow responsiveness to need for public communication

Role of the Red Book

The Red book was not used much but was essential to know it is there.

Areas of Focus for subsequent Crisis Simulations

In planning the next exercise, a particular concern should be to test the central elements of the national response to a financial stability event (i.e. financial analysis of an individual institution in difficulty, liquidity / solvency assessment, ELA procedures, Eurosystem / ECB aspects, systemic analysis, interacting with media / political level, communications between national authorities, resolution issues etc.) rather than areas which are, while still important, more peripheral

The main priority should be to test rigorously the financial, legal and policy assessments that underpin our 'model' of crisis management and also drawing out the possible conflicts of objectives that may emerge in the course of the management of an event in order to pre-empt the risk that these may arise in practice.

THEME: C1

Effectiveness of the ECOFIN and Domestic Standing Group (DSG) (Central Bank, Financial Regulator and Department of Finance)

LINE OF INQUIRY: C1c

Role, responsibilities and objectives of the Domestic Standing Group (DSG)

Summary

The overall assessment is that financial stability risks have on balance increased since the CBFSAI's Financial Stability Report 2006. The 2006 Report identified three major domestic vulnerabilities for financial stability: strong credit growth and rising indebtedness, upward momentum in house prices and the adverse impact of increasing repayment burdens on the health of the household sector. Since then, there has been a number of welcome improvements with respect to domestic risks. First, the upward momentum in residential property prices has abated, thus reducing the vulnerability posed by the previous substantial increase in house prices. Second, the rate of credit growth has eased and the rate of accumulation of private-sector indebtedness has moderated accordingly. However, issues have arisen with respect to the domestic economy arising from the longer-term deterioration in competitiveness, the moderation in the contribution of residential construction-sector activity to overall growth, and the possible effects of international financial-market turbulence. This turbulence arose as problems in the US subprime mortgage market broadened into a repricing of risk in a number of financial markets. Although this is a transition to a more normalised pricing of risk, the possible spillover effects from this adjustment could be important for financial stability both at home and abroad because of the potential impact on the banking sector and on the economy. However, the central expectation, based on an assessment of the risks facing both the household and non-financial corporate sectors, the health of the banking sector and the results of recent in-house stress testing is that, notwithstanding the international financial market turbulence, the Irish banking system continues to be well placed to withstand adverse economic and sectoral developments in the short to medium term.

Overall Assessment

Increased international uncertainty is associated with the fallout arising from problems in the subprime mortgage sector in the US. In early-2007, there was a sharp weakening in global equity markets, where the key driver was a negative re-assessment of the economic outlook in the US. This developed, later in the year, into the period of severe market turbulence mentioned above and was characterised by rising volatility, declining liquidity and a sharp repricing of risk. An important contributing factor was a significant heightening of concern, from mid-2007 onwards, about the exposure of a wide range of mortgage-related securities and structured credit products to mounting losses in the US subprime mortgage market. Uncertainty about the size and distribution of credit risk exposures and related losses caused risk aversion to heighten further. This triggered a sharp spillover from the ongoing repricing of credit risk generally to particularly negative sentiment towards the market for collateralised short-term financing. This disrupted banks' liquidity flows, as asset-backed commercial paper (ABCP) became increasingly difficult to rollover. Allied to the uncertainty about banks' exposures to risky assets, concerns about counterparty risk heightened and problems began to spillover to the interbank market. A number of central banks, led by the ECB, reacted promptly to alleviate these problems through the provision of substantial liquidity injections. These actions alleviated the problems at the very short-end of the interbank market, although longer-term rates have not yet fully adjusted and spreads between these rates and policy rates remain relatively wide. Overall though, the transition to a more normalised pricing of risk will be beneficial for international financial stability in the long run.

The possible spillover effects from recent volatility in financial markets are important for financial stability because of the potential impact on the real economy, both globally and in Ireland. The risks from the international economy relate to the heightened uncertainty about global growth prospects and increased investor nervousness, with the possibility that risk premia will rise and credit conditions will be tighter with adverse consequences for economic growth across the major regions. Forecasts from the major international economic institutions suggest that the downside risks are most pronounced for the US. While the resilience of the global and euro area economies should be helped by the fact that both were growing solidly before the recent outbreak of market turbulence, a marked slowdown in US growth would remove considerable impetus to activity in the rest of the world. In particular, the significant trade and investment links between Ireland and the US leave the Irish economy particularly vulnerable to any downturn in growth in the US. This international risk to the Irish economy is in addition to continuing issues about high and volatile energy prices and the possibility of further strengthening of the euro against the US dollar as part of a correction process for international current-account imbalances.

The international banking system has been negatively affected by recent events, both directly through banks' losses on their US subprime assets, and indirectly through holdings of investments exposed to US subprime losses, from credit commitments to conduits/special purpose vehicles, and from a general disruption to business. In this respect, the domestic banks report no significant direct exposures to US subprime mortgages and very limited exposures through investments and credit lines extended to other financial companies or special purpose vehicles. The domestic banks' shock absorption capacity has not been much reduced by these events.

Regarding the main domestic development, the significant easing in residential house price growth has reduced some of the key concerns noted in last year's Report. While house prices increased nationally by almost 12 per cent on average in 2006, they slowed significantly in the second half of the year. The slowdown continued in 2007 and prices are now about 3½ per cent lower on a year-to-date basis. These developments should be assessed against the gains in house prices in recent years. Furthermore, concerns that house prices would move further out of line with fundamentals and that housing affordability would worsen have lessened since last year's Report. Regarding future house price developments, factors such as investors' participation in the property market, the sustainability of current rates of immigration, the future direction of monetary policy and the performance of the labour market are all important. The underlying fundamentals of the residential market continue to appear strong. The central scenario is, therefore, for a soft, rather than a hard, landing.

The rate of accumulation of debt by households and non-financial corporates has continued to ease for a second successive year. However, the current rate remains high by international comparison. The ratio of private-sector credit to GNP in Ireland had increased in recent years reflecting the level of economic activity generally and, specifically, the increased demand for housing and investment activity. Although a high level of indebtedness increases the vulnerability of the private sector to income and interest-rate shocks, there are also important mitigating factors such as the sector's overall net worth and the positive outlook for the economy which, when assessed alongside the slowdown in borrowing, reduce this vulnerability somewhat.

Households' repayment burdens have stabilised somewhat since the publication of last year's Report but the outlook remains uncertain. Repayment burdens had stabilised because households' disposable incomes continued to grow robustly and budgetary tax changes helped offset the additional costs of some earlier interest-rate increases. The household sector remains, however, vulnerable to higher interest rates because the bulk of both the stock of existing mortgages as well as the flow of new mortgage loans are at variable rates.

Against a more uncertain international backdrop, the indications are that the domestic economy continues to perform solidly. The overall picture for economic growth is generally satisfactory in the current uncertain international environment and follows a period of high growth. On the positive side, economic fundamentals — a good budgetary position, strong employment growth, an adaptable economy — continue to be sound. The outlook is for some deceleration of economic growth in 2008, but growth projections remain reasonably positive by international standards. As economic growth slows, an upturn in the unemployment rate is likely. However, this is expected to be modest and the forecast is for the economy to remain at close to its full-employment position. Moreover, as domestic output growth weakens, inflationary pressures in the economy are expected to reduce.

Despite this relatively favourable economic environment, a number of risks remain and the concern is that the economy may be affected by several of these risks at the same time. From a domestic perspective, there are continuing concerns about the high, if declining, share of the construction sector in economic activity and the longer-term losses of competitiveness. The high share of construction is expected to decline gradually in the coming years, with the reduction in residential activity offset in part by continued strong growth in public sector and private non-residential construction. The deterioration in competitiveness reflects a number of factors including rising prices and production costs relative to our trading partners, the strengthening of the euro exchange rate, particularly against the dollar, and weaker productivity growth. Given the openness of the economy, Ireland is particularly vulnerable to global shocks. In addition to the current market turbulence, there are continuing issues about high and volatile energy prices as well as the further strengthening of the euro against the US dollar as part of a correction process for international current-account imbalances and uncertainties relating to the US economy.

There are two additional developments since the last Report which merit consideration. First, in contrast to the residential market, commercial property prices continue to appreciate at relatively high rates. The commercial property market performed strongly across all sectors (i.e., office, retail and industrial) in 2006 and early-2007, with capital appreciation reaching an annual rate of 24 per cent last year. The concern was not only that capital growth rates in the commercial property market were high, but they also appeared to have diverged from the corresponding rental growth rates such that yields were driven to unprecedented low levels. It is welcome, therefore, that the pace of capital appreciation has begun to ease, the divergence between capital and rental growth has begun to decline, and the long-run decline in yields in Ireland appears to mirror the international experience.

Second, there is the combined effect on the banking sector of low net interest margins and higher funding costs in an environment of lower volume growth. A combination of a slower housing market, somewhat slower economic growth and the impact of the current turbulence in financial markets on banks' willingness to supply loans, could all contribute to lower volume growth in the future. In the context of these vulnerabilities and risks to the economic outlook, a healthy banking system with good shock-absorption capacity is needed to support a stable financial system. The health of the banking system remains robust when measured by the usual indicators: solvency, profitability, liquidity, asset quality and market indicators. The central expectation, based on an assessment of the risks facing both the household and non-financial corporate sectors, the health of the banking sector and the results of recent in-house stress testing is that, notwithstanding the international financial market turbulence, the Irish banking system continues to be well placed to withstand adverse economic and sectoral developments in the short to medium term.

CBFSAI's Mandate

The CBFSAI's legal mandate is to contribute to the maintenance of financial stability in both Ireland and the euro area. Financial stability is an issue of major importance for both the Central Bank and the Financial Regulator. The key elements in the discharge of this mandate are to raise awareness of financial stability matters through initiatives like the publication of the annual financial stability report, maintaining a dialogue with domestic credit institutions in order to highlight issues for the financial system and, finally, to continue to develop procedures to deal with potential disruptive events and to facilitate an orderly resolution. In relation to cross-border financial institutions, the Central Bank and Financial Regulator maintain ongoing dialogue with their counterpart central banks and financial regulators.

Economic and Sectoral Commentary

Domestic Macroeconomic Outlook

Economic growth in the Irish economy remains strong and labour market conditions remain favourable, although the projections for growth in 2007 have been revised downwards marginally since the last Report. Last year the volume of GNP increased by 6.5 per cent with a corresponding increase in GDP of 5.7 per cent. While these rates of growth were somewhat above the estimated potential growth rate of the economy, slower growth is expected during 2007 and 2008. This partly reflects developments in the residential construction sector, the output of which appears to have peaked during 2006. Private consumption growth is also expected to moderate somewhat next year as the impact of maturing SSIA funds lessens. As a result, GNP growth is projected to fall to around $4\frac{3}{4}$ per cent this year with a further decline to around $3\frac{1}{4}$ per cent in 2008. The corresponding projections for GDP growth in 2007 and 2008 are $4\frac{3}{4}$ per cent and $3\frac{1}{2}$ per cent, respectively.

The labour market continues to perform well, although the projections for unemployment have been revised upwards slightly since the publication of the last Report. Total employment increased by 4.4 per cent in 2006, with particularly strong increases in construction (9.7 per cent), health (8.2 per cent) and wholesale and retail trades (4.6 per cent). Despite some well-publicised adverse employment news recently, the aggregate data indicate that the strong labour market performance looks set to continue. As economic growth slows, an upturn in the unemployment rate is expected. However, this is expected to be modest and the forecast is for the economy to remain at close to its full-employment position.

Domestic Macroeconomic Risks

Despite the relatively favourable economic outlook, a number of significant risks remain. First, from a domestic perspective, there are concerns about the continuing high share of the construction sector in economic activity. This is expected to decline gradually in the coming years with the reduction in residential activity mitigated in part by continued strong growth in public-sector and private-non-residential construction. However, a sharper-than-expected fall in housing output would have a negative impact on both GDP growth and employment.

A second domestic risk relates to longer-term losses of competitiveness. While the economy was in an extremely strong, but probably unsustainable, competitiveness position at the beginning of the current decade, the situation has subsequently deteriorated. As already noted, this has been due to a number of factors including rising prices and wages relative to our main trading partners, an appreciation of the exchange rate and lower productivity growth. While the overall competitiveness position of the economy does not appear to be too strained, judging from data on inward FDI flows, nevertheless, a continuation of underlying trends could lead to a more significant adjustment in the longer run.

International Macroeconomic Risks and Financial Market Developments

Given the openness of the Irish economy, its financial system is potentially vulnerable to global shocks and to the current developments in the international financial system. The most significant issue since the last Financial Stability Report has been signs of significant distress in the US subprime mortgage sector, which came to a head in early- to mid-2007. From late-June onwards, concerns were heightened about the exposure of a wide range of mortgage-related securities and structured credit products to mounting losses in the US subprime mortgage market, causing problems in the market for asset-backed commercial paper (ABCP), where investors were reluctant to rollover financing given the increased nervousness about the associated risks. Uncertainty about the size and distribution of credit risk exposures and related losses affected market conditions, and what started as a credit market sell-off quickly evolved into a bout of severe market turbulence characterised by rising volatility, declining liquidity and a sharp repricing of risk. Risk aversion heightened further when the problems — which, up to then, had been concentrated in hedge funds and US financial institutions involved in mortgage business — began to spread to the more broad-based banking sector internationally especially through banks' connections with ABCP conduits or structured investment vehicles. Thus, the generalised ongoing repricing of credit risk caused a drying up of liquidity in the collateralised short-term commercial paper market.

Allied to the uncertainty about banks' exposures to the repricing of risky assets, concerns about counterparty risk heightened from early-August and problems began to spillover to the interbank market. With banks becoming very reluctant to lend to one another, even at very short maturities, overnight rates began to rise sharply. A number of central banks — led by the ECB — reacted promptly to alleviate problems in the interbank money market through the provision of substantial liquidity injections. These actions succeeded in alleviating the problems at the very-short end of the interbank market, with overnight rates reverting to their earlier levels. Longer-term rates, however, have not yet fully adjusted and spreads between these rates and policy rates remain relatively wide. This is likely to place upward pressure on the cost of borrowing, as will the widening of spreads on lower-rated corporate debt. There is also the possibility that creditworthy borrowers will face some rationing of credit which could have adverse implications for global growth prospects.

Prior to the above events, the outlook for the global economy was favourable but there were also risks to the outlook which could have knock-on implications for the domestic outlook. The assessment made prior to the US subprime crisis was that the international macroeconomic environment had remained supportive of financial stability given its robust pace of expansion, in spite of high and volatile oil prices, a sharp slowdown in the US housing market and earlier financial market turbulence. Risks to the inflation outlook, however, had been tilted to the upside, relating to increased capacity utilisation, high oil prices and the prospect that wage pressures would intensify as labour markets improved. As a result, monetary policy had generally been either in a stable or tightening phase. While a broader economic assessment of the implications of recent events in international financial markets depends on the duration of disturbed market conditions and the associated uncertainty, the current assessment is that the overall outlook for growth remains positive although clearly downside risks have risen somewhat. A key consideration is that, even if market liquidity improves, risk spreads are likely to remain higher on a long-term basis than they have been in recent years.

Forecasts from the major international economic institutions suggest that the downside risks are most pronounced for the US. This reflects the view that the problems in financial markets are likely to intensify the downturn in the US housing market, where forward-looking indicators of conditions were pointing lower even before the recent turbulence began. In addition to the direct impact of US housing market weakness on

07/MMG/07.

Minister

From Secretary General

BRIEF FOR MINISTER FOR FINANCE, MAY 2008
MAIN POLICY ISSUES

1. The main priorities for the Department for the future.
We outline below the main priority areas and issues which we expect to be bringing to your attention in the coming months and beyond. More detailed briefing on these and on other priorities are contained in the attached separate folder.

Budget and Economic and Pensions Division: Mr. Jim O'Brien (Tab 1)

Budgetary and fiscal sustainability - ***A separate note on the emerging economic and fiscal position as we currently see it is attached.***

At Budget time real GDP growth of 3% for this year, averaging 3½% over the period 2008 – 2010, was forecast. At the time, this view was slightly below the general consensus. In the Budget we identified a number of risks – weaker Irish housing activity, the strength of the euro against the dollar and sterling, persistently higher oil prices, the fear of a US recession and prolonged upheaval on the international financial markets leading to a more general credit crunch outside of the sub-prime market. In the intervening period these risks either have materialised, or are now more likely to do so. **As such our current working assumption is that GDP growth for 2008 will be around 2% and average in the range 3 - 3¼% for the period 2008 – 2011.**

At end-April taxes were €736 million below profile – 45% of this shortfall is due to the poor performance of Capital Gains Tax. While it is very early to call an end-year position, **we are now factoring in a €2 billion shortfall in taxes but have not publicised this as yet**.

On the expenditure side, there are emerging spending pressures – including health, education and welfare payments from higher numbers on the Live Register. For the purpose of the detailed note on the emerging economic and budgetary position an overrun of €300 million on the Live Register has been assumed.

Thus in overall terms the Budget day Exchequer deficit of €4.9 billion is now likely to be over-shot by €2 billion and the General Government Balance is likely to be around -2.2% of GDP as opposed to -0.9% forecast on Budget Day. **This represents a significant worsening of the position for this year with serious consequential impacts for next year.** We are currently re-assessing the implications for 2009-2011 in the context of the draft Budget Strategy Memorandum (BSM) which we would aim to put before you for consideration in the next few weeks. The BSM is usually brought to Government in early July.

Continued success into the medium and long term will depend crucially on maintaining competitiveness and budgetary stability. Bringing current public expenditure increases down to sustainable levels – low single digits – will be crucial in that context.

• **Pensions Policy**

The Green Paper on Pensions was launched last October. This has been followed by a consultation phase which lasts until the end of May 2008. The Government will then begin the process of developing a framework for dealing with pensions over the long term. This will be a sensitive issue involving a balance between sustainability and pressures to improve cover and raise pensions levels. [Public sector pension reform will be an important component of the overall approach].

• **Long term issues/ageing**

These pressures present a key challenge for the future in relation to the sustainability of the public finances which need to be taken into account in Budgetary policy in the shorter term. A separate report is being prepared by an internal group. While such long-range reports cannot predict the future, they do provide a useful overall context for policy formulation. The key findings will relate to the very significant spending implications of a rapidly growing elderly population, inexorably leading to a need for some fiscal adjustments over time to ensure long-term fiscal sustainability. That sustainability is critical to achieving both sound economic conditions and to securing social progress. This report will be submitted to you soon. Another important long-term macro-economic challenge relates to the environment and, in particular, <u>Climate Change</u> (see Tab 3 – SPD).

• **EU International**

The <u>Eurogroup</u> and <u>Ecofin</u> (Economic and Financial Council of Ministers) meet once a month. <u>The next meeting is next week (Tuesday night/Wednesday)</u>. You attend this meeting accompanied by Mr O'Brien. Member States' economic and budgetary positions, the turmoil in the financial markets and the supervisory arrangements for financial institutions dominate discussion at this stage. Ireland's economic and fiscal position is expected to be discussed at the June Council. The debate on the Review of the EU Budget is expected to start in earnest later this year. This could have major implications for Ireland post-2013, in particular, in relation to the monies we receive from and have to pay in to the EU.

• **Annual Meetings of the IMF/World Bank**

The Boards of Governors of the International Monetary Fund and World Bank Group are scheduled to meet in Washington DC on 13th October 2008. As Governor for Ireland at both institutions, the Minister is invited to attend the Annual Meetings and to present a statement setting out key issues and strategic priorities for Ireland's involvement in the institutions. (Ministers do not always attend.)

• **NTMA**

The Chief Executive (Mr Michael Somers) reports direct to you on NTMA matters [Management of Debt portfolio (which now has to accommodate raising new debt) State Claims Agency, NDFA]. There is an NTMA Advisory Committee chaired by Mr David Byrne.

• **Pensions Fund**

There is a Pensions Commission chaired by Mr Paul Carty who reports to you as required, along with Michael Somers – the NTMA is the manager of the Fund.

<u>Public Services Management and Development: Mr. Ciarán Connolly</u> (Tab 2)

- **Pay and social partnership (Towards 2016):** *Towards 2016* is a ten-year framework social partnership agreement. The first pay agreement under *Towards 2016* expires at various dates in the private sector and at the end of September 2008 in the public service. As regards the overall framework agreement a review is to take place during 2008 of outcomes achieved in relation to the overall goals and any opportunities arising to refocus and reprioritise.

  Negotiations on the next pay agreement and the review of the broader framework began on 24 April 2008. Keeping pay increases in the public and private sectors to levels which will not further undermine our competitiveness is key. This strand will also encompass some difficult workplace issues, e.g. agency workers, union recognition. In the review of the overall framework any adjustments can only be made within existing budgetary parameters and cannot add to net overall expenditure commitments.

- There is a range of major **industrial relations issues in the health sector** which are critical for the reform of the sector. There is still a possibility of a dispute affecting nurses on pay issues but not immediately. Bringing the negotiations on the hospital consultants' contract to a conclusion is proving extremely difficult.

- The Department has responsibility for public service modernisation. Consideration of the **OECD report "Towards an Integrated Public Service"** and implementation of Government decisions arising therefrom will be a priority. Key issues arising include strengthening the citizen-focus of all public services, increased mobility and flexibility across the sectors of the public service, setting up a Senior Public Service to provide a single Public Service leadership cadre; improved governance and performance dialogue to address the current disconnects between the central civil service and the wider public service; establishing clear guidelines and criteria for establishing new agencies and for operating existing ones; developing e-*Government* to achieve a more citizen centred approach. The structures to develop and implement the Government's response to the report have to be decided.

- Continued development of 'E-Government' of the civil and wider public service is an ongoing issue.

- **Decentralisation:** The Decentralisation Implementation Group (DIG) is reviewing the position on State agencies – this part of the programme is posing particular problems. A sub-group of Secretaries General is reviewing the accommodation, management and other needs in Dublin for the nine Departments and Offices whose headquarters are relocating. On publication of the latest report of the DIG in October, 2007, it was expected that over 6,000 posts would have relocated by end-2009. The DIG are currently updating the position and early indications suggest that there are likely to be some slippages in the previous timeframes.

- **Legislation**: The Ethics in Public Office (Amendment) Bill 2007 has been passed by the Seanad. A number of Government amendments are to be proposed in the Dail. Drafting of the Ombudsman (Amendment) Bill is nearing completion.

<u>Sectoral Policy Division: Mr. Donal McNally</u> (Tab 3)

- The immediate objective is to ensure that Departments keep to Budgets in 2008. There are already emerging pressures on the social welfare side (up to €300 million because unemployment figures are higher than allowed for in the Budget); and in health and education.

- The next imperative is to reduce the rate of increase in current spending for 2009 to the expected weaker growth in resources. This means that given the very low growth in resources likely next year, the target for growth in current expenditure must be kept to very low single digits. This will be difficult given the expectation for ongoing improvements in social services (S/Welfare, Health, Education) and pay expectations.

- On top of this we will have to drive for efficiency in the delivery of Public Services together with value for money. Responses from Departments in relation to the efficiency drive initiated in the 2008 Budget were disappointing and this Department has prepared a draft Memorandum for Government for consideration of appropriate action which will be submitted to you shortly.

- Maintaining the level of public capital investment is important, but this will require discipline on the rest of the Budget.We need to maintain a high rate of capital spending (5% to 6% of GNP) to enable Ireland to firstly address a historical deficit and secondly to grow at higher rates over future years. The NDP (2007-2013) and Transport 21 set ambitious plans for capital investment. On the basis of current expenditure being tightly controlled, borrowing for productive capital investment can be justified in a country with very low debt/GDP ratio like Ireland.

- Further reform of the Budget process is needed in order to move to multi-annual current Budgets and to link up Departmental outputs with the resources actually provided. This will be a priority in 2009.

- We are currently aiming to meet our Kyoto targets through the policies outlined in the National Climate Change Strategy. A far more significant challenge will be to meet the targets emerging from the current discussions on EU legalisation to reduce emissions (by 20-30%) in the EU by 2020. These negotiations need to be closely monitored and will have significant economic and social implications.

<u>Taxation and Financial Services Division: Mr. Kevin Cardiff</u> (Tab 4)

- **Commission on Taxation**
  This is chaired by Frank Daly and has been asked to report by September 2009 at the latest. It has been given a wide ranging terms of reference, being charged with addressing social, economic and environmental issues. At the same time, it must put forward policies which will deliver the funds necessary to fund public services.

- **Taxation policy.**
  Development of a tax package for Budget 2009 will be a challenge in current circumstances. In the meantime, we will be starting preparations for the 2009 Finance Bill. The changeover to the new Vehicle Registration Tax system, provided for in this year's Finance Bill, will take place in July. Tax policy issues may also feature in Social Partnership and Pensions Green paper discussions but the room for manoeuvre will be very difficult in the current fiscal circumstances.

- **Income Tax rates.**
  This will require to be dealt with as part of the Budget 2009 package

- **EU developments on tax.**
  Issues in relation to proposals for a Common Consolidated Corporate Tax Base (CCCTB), and VAT issues dominate our EU agenda at present. As regards CCCTB, we have been under considerable pressure from the Commission, but extensive efforts to develop an alliance of sceptical member states, in conjunction with the Department of Foreign Affairs, appear to be bearing fruit, and there should be considerable opposition to any proposal which the Commission might issue later this year. Commissioner McCreevy has been a vocal opponent of the proposition. We are also under pressure from the EU to change various elements of our tax code in relation to which they argue that we are infringing either Treaty or directive provisions.

- **Revenue Commissioners**
  The Minister normally meets with the Chairman (Josephine Feehily) about every month for an update on the administration of the tax system.

- **Financial services issues**
  Domestic and EU developments. Considerable attention is being paid to some crucial EU financial services directives and policy issues as well as strengthening financial stability planning arrangements working with the Central Bank and the Financial Regulator. Liquidity in financial markets is creating a challenge for credit institutions internationally, many of which are reducing their ambitions in relation to lending. Ireland is not an exception to this. <u>You will be briefed orally on this by the Governor of the Central Bank at the first available opportunity</u>. Normally the Minister meets with the Governor about every month or two months.

- **Other**
  We are also expecting the outcome of discussions between the Registrar of Credit Unions and ILCU on the reform of the Savings Protection Scheme for credit unions

2. Staffing (Tab 5)
Regarding staffing and other needs of your office, the Personnel Officer, Mr. Des O'Leary is available to deal with any issues that arise. You are being provided with separate material dealing in more detail with the staffing of the Department, including the Minister's Office.

3. Statement of Strategy (Tab 6)
You are also being provided with a copy of the Department's Statement of Strategy 2008-2010. This sets out our mission and the strategic priorities that ensure the mission is successfully fulfilled.

You will be aware that Section 4(b)(ii) of the Public Service Management Act 1997 requires the Secretary General of a Department to submit to the Minister a strategy statement in respect of that Department within six months of the appointment of the Minister or at an earlier time if the Minister so requires. Accordingly, we will prepare a new strategy statement for the Department to be submitted to you.

4. EU legislation/ infringements (Tab7)
The attached brief includes material on EU legislation/ infringements relevant to this Department.

5. Some Key Dates
Some key dates that are likely to arise over the next few months are set out below. Oral PQ dates are not included since these will be rescheduled to reflect the composition of the new Government.

13-14 May	Eurogroup/Ecofin (Brussels)
2/3 June	Eurogroup/Ecofin (Frankfurt/Luxembourg)
11 June	North South Ministerial Council (tentative, N.I. venue)
Early July	Budget Strategy Memorandum to Government
7-8 July	Eurogroup/ Ecofin (Brussels)
12-13 September	Informal Eurogroup/ Ecofin (Nice, France)
6-7 October	Eurogroup/Ecofin (Luxembourg)
Mid-October	Pre Budget Outlook published
10-13 October	IMF/ World Bank meeting (Washington D.C.)
17-31 October	Ministerial Bilaterals on Budget Day expenditure provisions
3-4 November	Eurogroup/ Ecofin (Brussels)
1-2 Dec	Eurogroup/ Ecofin (Brussels)
3 December	Budget Day*

*Budget day is traditionally held on the first Wednesday in December which is early given that some large taxes are paid at end-November. The more detailed budget calendar can be found under the Divisional briefing on BEPD at Tab 1 and is based on a 3 December date in line with tradition. Your approval will be required in due course in terms of the actual date.

6. Detailed Briefing for Each Division
I am available, together with the management of each of the Divisions, to go through the issues set out above and in the attached briefing notes in more detail.

7 May 2008

between them account for almost half of the total FDI stock in Ireland, largely due to their role as intermediaries for US investment.

FDI by Ireland abroad

Irish residents invested €11.7 billion abroad in 2006, compared to €11.9 billion in 2005. The cumulative stock of Irish FDI abroad rose by €5.3 billion in 2006 to €93.6 billion. In the first three quarters of 2007, Irish residents directly invested another €13.3 billion abroad.

18% of the stock of Irish FDI abroad in 2006 was invested in manufacturing enterprises, with the rest in services. Included in services investment is the financial intermediation sector, which accounted for 35% of the total FDI stock. Other services activities, the bulk of which relates to property investment, accounted for 30% of FDI stock. The end-2006 position for Irish FDI abroad was 26% invested in the UK, 41% in the rest of the EU, 12% in the US and 21% in the rest of the world.

	FDI in Ireland	Irish FDI Abroad
Manufacturing	27%	18%
of which Chemicals	9%	3%
Services	73%	82%
of which Financial/Insurance	57%	35%
of which Property	NA	30%

Financial Stability: Banking on Prudence

General comment

The Irish authorities welcome the recognition in the report that the Financial Regulator;

1. is a highly respected institution,
2. has been recognised as such in IMF reports on the regulatory system, and
3. had acted proactively in introducing forward looking liquidity regime in advance of recent financial market turmoil.

The report also correctly points out that the Irish banking system entered the current period of international financial turmoil in a particularly strong position in terms of earnings and asset quality. While there has been an ongoing adjustment in housing prices since the latter half of 2007, the most recent Financial Stability Report (14 November, 2007) prepared by the Central Bank and Financial Services Authority of Ireland reported that the Irish banking system continues to be well placed to withstand adverse economic and sectoral developments in the short to medium term. That report highlighted that:

- When assessed on the usual indicators such as asset quality, profitability, solvency, liquidity and credit ratings, the Irish Banking system is robust.
- There have been a number of welcome improvements with respect to domestic risks since the Financial Stability Report 2006 was published.

- The upward momentum in residential property prices has abated, thus reducing the vulnerability posed by the previous substantial increase in house prices.
- Fundamentals in the Housing market remain strong.
- The rate of credit growth has eased and the rate of accumulation of private-sector indebtedness has moderated accordingly.

- The strength of the Irish economy continues to support the stability of the financial system. Growth projections (though subsequently reduced) remain positive and reasonably good by international standards in light of current global economic conditions.

Consideration of issues in the adjustment in Irish property prices should have regard to this assessment, Ireland's participation in the ESCB and the wider EU economy.

General comment on Deposit Guarantee and bank insolvency regime

Ireland's approach to Deposit protection and banking insolvency sits squarely in the mainstream of European law and practice. Ireland is one of 10 of the EU countries (some of which are considerably larger economies), which provide deposit protection to a level of €20,000 as provided for in EU Directive 94/19/EC, sufficient to provide protection to the vast majority of depositors. Similarly, while there is provision in some EU countries for special treatment of banks within insolvency law, Ireland's approach is consistent with the majority of its European partners[8].

In circumstances where the Irish approach to these issues is consistent with the majority of our European partners, the Irish authorities cannot accept comment relevant to the general reform of these schemes that is articulated in a report unique to Ireland. Any such comment should, in the first instance, be directed to a review of general (European) practice, such as the review of Deposit Guarantee Schemes currently being undertaken in the context of the EU Roadmap in response to financial market turmoil. While this is the strongly held position of the Irish authorities, it is particularly important in the current circumstances where such comment, if positioned in the context of a particular country, could be misinterpreted or misrepresented in relation to financial stability issues. In this context, the Irish authorities note the high standing and reputation of the OECD in Ireland and other countries, underlining the need for care and proper consideration to be given to the potential impact of any comment it might make, particularly where such comment relates to matters that have relevance to the national economy.

Recommendations in Box 3.1

Consider making pay-outs from the deposit guarantee scheme faster and increase the guarantee fund.

Comment

While the EU Financial Services Committee has identified speed of payment as a critical issue in its review of Deposit protection Schemes, it has identified significant

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[8] It is noted that the UK, a similar common law jurisdiction to Ireland, has commenced a public consultation process in relation to Financial Stability and Depositor Protection, including consideration of a Special Resolution Regime (SRR) to reduce the impact of a failing bank.

challenges to be overcome; pointing out that speed of payment is dependent on information on depositors and funding, acknowledging that creating a system for near instantaneous information availability may impose high administrative costs on banks and supervisors. Ireland is currently participating in an EU review looking into the possible enhancement of deposit guarantee schemes within the EU. The parameters of the Irish deposit insurance scheme will be reconsidered in the light of the findings of the EU study. As indicated above, the Irish authorities consider it inappropriate that this recommendation be positioned in a report on a particular country, or that it anticipate the outcome of work at European level in which Ireland is participating.

Implement an insolvency procedure specifically adapted to banks.
Comment:

The introduction of a special insolvency regime for banks would require a radical change in the Irish statutory insolvency regime and could not be undertaken without wide consultation and careful study to assess its full implications. One of the main underlying objectives of a special insolvency regime for banks is to expedite payments to depositors in the event of a bank failure. It may be possible to achieve that objective through other reforms to the deposit insurance arrangements. Again, the Irish Authorities consider it inappropriate that this recommendation be positioned in a report on a particular country.

While the foregoing paragraphs relate to deposit protection and insolvency regimes, the report (Box 3.1) also makes recommendation in relation to ratings agencies and approaches to off-balance sheet exposures. Here again the Irish authorities are participating in work at European level in relation to enhancing transparency and the role of ratings agencies. The latter in particular are not amenable to action by one, small, country. The Irish authorities would be concerned at the presentation of these recommendations in a report on one country.

General speaking point

- The Irish authorities welcome the recognition in the report that the Financial Regulator;
  1. is a highly respected institution,
  2. has been recognised as such in IMF reports on the regulatory system, and
  3. had acted proactively in introducing forward looking liquidity regime in advance of recent financial market turmoil.

- The report also correctly points out that the Irish banking system entered the current period of international financial turmoil in a particularly strong position in terms of earnings and asset quality - this positive assessment is borne out in the most recent assessment of the Irish Banking system in the CBFSAI's Financial Stability Report (14 Nov. 2007).

- Ireland's approach to deposit protection and banking insolvency sits squarely in the mainstream of European law and practice.

- In circumstances where the Irish approach to these issues is consistent with the majority of our European partners, the Irish authorities cannot accept comment relevant to the general reform of these schemes that is articulated in a report unique to Ireland.

- Furthermore, while reform of both deposit protection and insolvency arrangements is advocated in the report, there is no analysis as to the appropriateness, cost effectiveness or workability of these recommendations in an Irish context.

- Having regard to the standing and reputation of the OECD in Ireland and other countries, care and proper consideration needs to be given to the potential impact of any comment it might make, particularly where such comment relates to matters that have relevance to the national economy or financial system.

- The Irish authorities note the report's caution (par 93) against going "into regulatory overdrive" in response to financial market turmoil, a position that is difficult to reconcile with report's advocacy of profound change in relation to deposit protection insolvency legislation for banks.

Deposit Protection Scheme (Deposit Guarantee Scheme - DGS), Speaking Point

- The Irish Deposit Guarantee Scheme complies with the EU Deposit Guarantee Directive and would provide protection to over 90% of depositors

- Ireland's approach to Deposit protection sits squarely in the mainstream of European law and practice. Ireland is one of 10 of the EU countries (some of which are considerably larger economies), which provide deposit protection to a level of €20,000 as provided for in EU Directive 94/19/EC.

- The EU Commission and the Financial Services Committee (FSC) have been requested by ECOFIN to consider possible enhancements of deposit guarantee schemes and to report back to it by mid-2008.

- Ireland is participating in an EU review and the Tánaiste and Minister for Finance has made it clear that the parameters of the Irish deposit insurance scheme will be reconsidered in the light of the findings of the EU study.

The Irish authorities cannot accept either the positioning of a recommendation for the reform of the Deposit Protection Scheme in a report on a single country, or that a sustainable case has been made for the recommendation advanced

1. Work on the review of the Deposit Protection Scheme is underway at EU level, and it is inappropriate to position a recommendation pre-empting the possible lines of reform in a report on a single country.

2. There is no analysis in the report as to the costs, benefits or changes that would be needed to make an enhanced DGS operable – in this context the views of the UK Banking industry as to the costs of to consumers of enhancing DGSs in that jurisdiction are relevant.

3. EU Financial Services Committee has identified speed of payment as a critical issue in its review of Deposit protection Schemes, but that there are significant

challenges to be overcome in this regard; pointing out that speed of payment is dependent on information on depositors and scheme funding, acknowledging that creating a system for near instantaneous information availability may impose high administrative costs on banks and supervisors. The OECD's report offers no consideration or analysis of these issues.

4. The report does not explain role is envisaged for a DGS i.e. is its primary purpose as a crisis management tool or consumer protection issue (or both), which has important implications for public authorities in terms of their overall financial stability contingency planning

5. Overall there is an absence of application of Regulatory Impact Analysis (e.g. effectiveness, proportionality, necessity) or testing of the recommendation as to its likely advantages nor is there any analysis to suggest it would it pass a CBA or Impact Assessment test.

6. While a good deposit protection regime can help support confidence in the banking system, it is difficult to conceive (nor does the OECD report provide any suggestion) as to how a deposit protection scheme could be put in place that can altogether pre-empt banking crises unless it provides such strong guarantees that it is causing major moral hazard.

Implement an insolvency procedure specifically adapted to banks

- The best safeguard of financial system is the existence and effective operation of the financial regulatory and supervisory regime and the system in Ireland has been positively assessed by the IMF as recently as September, 2007

- Ireland's approach to banking insolvency is consistent with the majority of its European partners.

- To attempt to introduce a special insolvency regime for banks would require a radical change in the Irish statutory insolvency regime and could not be undertaken without wide consultation and careful study to assess its full implications.

- Work to date on financial stability issues has not highlighted insolvency law as a major issue for the reform process overall

- While the report presents some analysis of the functioning of a special insolvency regime for banks in the US, this needs to be understood in the context of the US market with a large number of relatively small banks, presumably catering for local savers fail (with a relatively high frequency of failure). While it makes sense to a have access to an insolvency regime which allows you re-unite depositors with their savings and wind-up the institution concerned quickly in such circumstances, the report makes no analysis of the differences in banking practice, regulation or size in an Irish (or European) context

The Report sets out no analysis to justify the introduction of a special insolvency regime for banks either in Ireland or generally in Europe and this recommendation is unacceptable as currently presented.

1. The creation of a special insolvency regime would 'carve out' a special position for retail depositors, but could have significant 'unintended' consequences on investor perceptions of banks and their ratings in view of the impact it would have on the ordering of other creditors. The OECD report provides no analysis or insight as the broad range of considerations that would be needed to inform this analysis

2. As in the case of Deposit protection, the report makes no analysis as to whether a special insolvency regime is intended as part of the toolkit for crisis management or whether it is considered a better way of protecting the interests of depositors than a deposit guarantee scheme.

3. Again, as in the case of deposit protection, there is an absence of application of Regulatory Impact Analysis (e.g. effectiveness, proportionality, necessity) or testing of the recommendation as to its likely advantages nor is there any analysis to suggest it would it pass a CBA or Impact Assessment test.

4. for a large sophisticated financial institution in Ireland, insolvency by its very nature it likely to be substantially more complex and unlikely to lend itself to such a 'quick-fix'....the scope for a 'carve-out' of some retail depositors would presumably promote behavioural changes among wholesale / corporate depositors and indeed wholesale lenders and investors. The report provides no guidance as to how a special regime could be designed that would seek to return all deposits (particularly given that it would come into play in circumstances that the institution was insolvent - unable to meet its obligations)

Additional material – Colm Breslin

On the basis of its views in relation to the Irish Deposit Guarantee Scheme (DGS), it would appear that the OECD needs to rethink and articulate its views as to the role and impact of DGSs in crisis management in the banking sector.

The CBFSAI has indicated that our EU-Directive compliant compensation ceiling of €20k would meet the needs of 90% of retail depositors. At the time that Northern Rock got into difficulties, its compensation ceiling stood at £35k (€52.5K approx) and it can be assumed that the vast majority of Irish-based depositors would have been fully covered by this ceiling. Moreover, the DGS is independent of and external to the bank in trouble. Nevertheless there was a run on the bank by, inter alia, its Irish-based depositors.

Clearly, therefore, the level of the DGS and the fact that it is independently secure is immaterial to depositors when they are considering their response to a bank in trouble. The OECD might therefore need to reconsider its views as to the role and impact of DGSs in the context of a bank crisis.

Fiscal Council

As regards a National Fiscal Council, the ESRI and the Central Bank provide a de facto non partisan expert advice in the public debate on fiscal policy. It would be inappropriate to try to impose what appears to be a congressional style budget committee approach on a parliamentary democracy.

Housing

General

It is difficult to disagree with the general thrust of the analysis of the state of the Irish housing market, which, in any event seems to be broadly positive, while recording some fairly well known risks. Regarding the comments and suggestions on policy relating to the housing market, the idea of considering the approach to policy in this area may be worth exploring, but without prejudice to the particular suggestions put forward. These mainly relate to aspects of fiscal policy impacting on the housing market, which is a matter for the Department of Finance.

One further general point in relation to the housing market analysis is that a more nuanced approach would be desirable with regard to the relative importance of different factors impacting on the market at different times. In particular, there is a distinction to be drawn between the earlier phase of expansion and price increase up to around 2004, which, as the economic modelling results cited in the report indicate broadly mapped the growth pattern in economic fundamentals, and the escalation post-2004, which departed significantly from the fundamentals due, it would seem, to the impact of other factors. This issue is dealt with further in the specific comments under.

Specific Aspects

Tax Treatment of Housing

The tax-related issues referred to are matters for the Department of Finance. However, a general conclusion that seems to emerge is the desirability of attuning fiscal measures as closely as possible to changes in the market.

The suggestion about moving towards a system of means-tested benefits would need to be treated with caution. Indeed it is not desirable that a specific recommendation in that regard should be included without rigorous justification. There is a very wide body of literature about the housing benefit approach internationally and significant difficulties (not least practical issues such as cost, complexity and administrative difficulty) as well as possible advantages, have been identified in different countries. The issue was looked at in the Irish context by a series of Committees which examined the rent supplement system and related housing issues in this country since the mid 1990s and the balance of arguments was found to be against such a move. Indeed the Rental Accommodation Scheme (RAS) can be regarded, to some extent as an alternative to such an approach. RAS is designed to take account of the particular issues that arise in the housing sector in Ireland while addressing disadvantages with the SWA rent supplement scheme as a means of providing long term housing assistance and avoiding problems that have been encountered elsewhere with housing benefit approaches. Further material can be provided to OECD on these issues if required.

Mortgage Lending Policy

There seems to be an implication that increased lending was largely or entirely a consequence of booming property markets (e.g. "This raised bank lending substantially...") whereas the converse was to a significant degree the case. There were significant changes in mortgage lending practices around 2005 (100% mortgages marketed aggressively at first time buyers, 35 and 40-year loans and interest-only mortgages). This helped to fuel price escalation directly through increased liquidity in the market and also through interaction with price expectations, on which expansive lending was partly predicated.

House Prices

The statement that house prices could even fall below their medium-term sustainable level is questionable. It is not entirely self-evident what the 'medium-term sustainable level' is and prices arguably have scope to reduce more to unwind the escalation that occurred in 2005/06 without being considered abnormally or unsustainably low. Notwithstanding recent cooling, there are probably still affordability problems in some areas, particularly in Dublin. Reference to lending and price expectations as factors helping to drive prices would is warranted

While sales are down throughout the housing market, the statement that "Residential investment is experiencing a sharp slowdown" seems too strong. Indeed there are some counter indications such as developers releasing blocks of units to the rental market, lack of evidence that the share of lending to this sector has declined appreciably (the Central Bank has reported a large proportion of lending stock in the residential investment sector). In addition rental yields have been growing in response to decline in capital values and demand from potential homeowners and new immigrants. Such yields should entice investors into the market as house prices may be perceived to be better value for money for investors as well (especially given the negative performance in equity markets).

Increasing Rents

Reference to recent rent increase should be balanced by indicating that the longer trend is quite moderate e.g. since December 2001, an average increase of just over 2% per annum and almost certainly a decline in real terms. Apart from affordability (which is improving) a factor in increased renting is that people are holding off buying because they expect prices to fall further.

There would appear to be a degree of anomaly in concluding that the recent rise above the fundamental trend has been driven by higher incomes and demographic factors – surely the latter would be included as "fundamentals" in the economic model. Again, this brings additional factors such as lending and price expectations very much into the picture. Points such as "This may overstate the effect on prices of demographic effects given that the large number of migrants who arrived in the past two years are more likely to rent and live in high density housing" does not seem correct. It is immaterial whether an immigrant household is accommodated in a rental or owner-occupied unit – they are adding to overall demand for housing and thereby exerting some influence on price in either case.

Housing Benefit and Social Housing

We would have serious difficulty with the unqualified endorsement of housing benefit. It is not feasible to deal with the fiscal aspects in this context. However, the general thrust of the OECD view about the need to have regard to alternative approaches in the absence of monetary policy instruments would seem to warrant consideration. The recent cycles of escalation and downturn would seem to lend credence to this but particularly the fact that, although trends in mortgage lending were identified in mid-2005 as a significant threat to house price moderation, it did not prove possible to pursue any action to moderate this factor.

We would question the comment "no progress" in relation to social housing and tenure options. We would very much feel that the RAS scheme represents important progress in this general area which should develop significantly in the future as an additional option in meeting social housing need in partnership with the private sector. On the question of possible change in relation to mortgage interest relief, while the economic rationale for the OECD view is noted, any possible changes in that regard would need to take account of prevailing market conditions.

Integration/Migration

Comment on current policy – language usage:

As a general rule we do not use the word assimilation we use integration. They are not interchangeable. Assimilation is used throughout the report, this is not Irish Government policy.

General Observations:

Over 1 million euros was spent by the HSE last year on interpretation services alone, but giving only this figure doesn't provide the full picture. In the education area, there are now over 1,900 English language resource teachers in place which will cost over €120m as compared with the situation in 2001/2002 when there were 260 such teachers. In addition, the DES funds Integrate Ireland Language and Training (IILT) and the National Council for Curriculum and Assessment (NCCA) have prepared materials to help schools cater for the integration of the migrant children.

24 January 2008

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CONFIDENTIAL

Financial Stability Issues – Scoping Paper

1. Introduction

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

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

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

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

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

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

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

3.1 CBFSAI role in this situation

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

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

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

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

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

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

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

3.3 Impact of ELA provision on confidence in the institution

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

4.1 Definition of systemically important institution (TBTF)

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

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

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

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

4.2 Role of CBFSAI if an institution is insolvent

It is important to note that the CBFSAI is legally prohibited from providing ELA to an insolvent institution. As referred to above, it will be difficult particularly in a crisis situation to differentiate clearly between an illiquid and an institution at risk of insolvency. In any event an illiquid institution can quickly become insolvent. It is therefore essential that there is close co-operation, co-ordination and communication between the three institutions comprising the DSG to ensure that the tools available to manage a crisis situation are effectively deployed in a crisis situation.

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

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

4.3 Role/Legal powers of the Minister in this situation

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

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

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

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

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

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

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

4.4 Principles guiding public intervention

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

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

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

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

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

Common Principles for cross-border financial crisis management

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

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

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

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

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

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

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

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

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

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

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

Appointment of a receiver for all or part of the assets

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

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

There are three form of winding up:

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

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

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

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

- in the interests of depositors.

Liquidation has a number of practical effects:

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

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

Appointment of an Examiner (Court Protection)

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

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

Critical Banking Functions

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The two possible uses of the DGS identified are:

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

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

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

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

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

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

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

<u>Urgent Next Steps</u>

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

<u>Company Law intervention Mechanisms</u>

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

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

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

Appointment of a receiver

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

Appointment of a liquidator

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

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

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

Members and creditors voluntary winding up

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

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

Compulsory winding up under a Court appointed liquidator

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

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

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

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

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

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

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

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

Appointment of an Examiner (court protection)

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

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

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

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

13 The examiner has 2 principal functions:

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

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

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

Appointment of Inspectors or intervention of the Director of Corporate Enforcement

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

Structural Changes to the Company

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

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

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

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

Stock Exchange considerations

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

Some Tentative Assumptions and Conclusions

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

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

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

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

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

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

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

Goodhart approach to deposit protection

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

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

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

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

8 February 2008

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Overview of Financial Stability Resolution Issues

Department of Finance

Friday, 8 February 2008

SECRET

Context

- EU requirement for national contingency plans for crisis resolution
- Report-back due for April ECOFIN (report to FSC in March)
- CBFSAI 'Red Book' in place
- Work has commenced on DoF operational manual based on
  - Scoping paper & CBFSAI comments
  - legal advice from Office of the Attorney General
  - Lessons from Crisis Simulation Exercise (December 2007)
- Policy decisions required to finalise a number of key "resolution" issues highlighted by work of the DSG to date

National Contingency Plans

- Integrated and consistent national approach essential
- Individual organisational plans will reflect different roles and responsibilities in effective crisis management and crisis resolution
- Must be soundly based on rigorous analysis and research on
  - Legal consideration governing crisis management
  - Preferred solutions (national policy objectives)

Previous conventional wisdom

- Intervention only if institution considered TBTF
- Otherwise institution should be allowed to fail
- Request to CBFSAI for ELA provision from financial institution
  - inauguration of financial stability event
  - lead responsibility for crisis management during that phase residing with CBFSAI
- Department's direct involvement predicated on the emergence of 'solvency' as opposed to 'liquidity' issues

Current viewpoint

- If confidence fragile then small institution could trigger systemic difficulties which suggests all institutions are TBTF (in current market environment)
- 'Market discipline' may not be useful tool as insolvency (let it fail) not practical owing to weaknesses in DGS
- Increasing consensus that a "support operation" likely to trigger wider systemic problem
- Also 'solvency assessment' could often be an abstract / contentious exercise reflecting such issues as information gaps and valuation uncertainties, shaped by strict accounting / legal definitions, influenced by market conditions and particular assumptions

Current viewpoint continued…

- In identifying the way forward very important to differentiate between short- & medium- term actions / policy responses feasible
- Current contingency plans must be designed around what is currently permissible under the existing legislative framework and what might be changed over relatively short timeframe
- Unlikely that more fundamental structural reforms if concluded to be desirable (e.g. special insolvency regime for banks) could be achieved quickly

Lessons from recent crisis management

- Every crisis has unique characteristics but has common themes
- There are risks from extrapolating too strongly from Northern Rock experience, but it would be prudent to examine particular lessons:
  - Announcement of BoE support operation triggered bank run in Northern Rock and risked systemic crisis
  - DGS did not maintain public confidence
  - Resulted in very substantial public exposure (BoE loans, HMT guarantees)
  - Highlighted the risk in those circumstances that to maintain financial stability the State is left with no option other than to provide open-ended 'guarantees'

Lessons continued…

- **Key question – could Irish financial system accommodate crisis resolution approach adopted by UK for Northern Rock? (e.g. would the scale of lending / State "guarantees" required be credible)**
- With the benefit of hindsight, 'covert' private sector takeover presented as *fait-accompli* to market preferable approach
- Issue for financial stability planning in Ireland is whether covert takeover legally feasible
- If so, how financial stability planning can be designed to expedite / maximise the prospect of success

Proposed framework for crisis resolution

- Overarching Principles
  - Earliest possible warning / identification of possible threats to financial stability and swift resolution critical[1]
  - Need for a number of options for early intervention

[1]CB/FR to have, on a continuous basis, all information for ongoing assessment of sustainability of financial institutions

Proposed framework for crisis resolution cntd.

- Three primary options should ideally be available for consideration in advance of any financial stability issue coming into the public domain:
  - Orchestrated market-based solution (i.e. non-publicly organised private 'take-over' / re-capitalisation – depending on scale may require involve Irish banks, international banks, outside investors)
  - Examinership (may not be readily available – consideration of reform of DGS required to underpin credibility)
  - Nationalisation as a last resort but to pre-empt requirement for extended period of ELA support and attempted public rescue

Framework for crisis resolution contd.

- The three primary options should ideally be available for consideration in advance of any financial stability issue coming into the public domain:
- **As a matter of public policy to protect the interests of taxpayers any requirement to provide open-ended / legally binding State guarantees which would expose the Exchequer to the risk of very significant costs are <u>not</u> regarded as part of the toolkit for successful crisis management and resolution**
- Legal advice obtained from the Office of the Attorney General on key aspects of the proposed framework
- In overall terms legal assessment favourable

MAD & ELA provision

- A financial institution could postpone disclosing to the market information that prompts a negotiation for ELA, provided that:-
  - the failure to disclose would not be likely to mislead the public (key issue identified by the OAG) and
  - the financial institution was able to ensure the confidentiality of the information
- Requirement of a *legitimate interest* would probably be met in these circumstances
- Strict obligations of confidentiality would apply to CBFSAI and DoF
- CBFSAI would be under obligation to ensure that MAD obligations are complied with
- Definitive advice could only be given in a particular context having regard to the two conditions above
- Impact of ISE rules require further examination

Takeover Rules

- Public authorities could facilitate the non-public takeover of a distressed financial institution **if** the Takeover Panel granted a derogation from its Rules given the exceptional circumstances
- This waiver would also meet MAD requirements
- Competition clearance likely to be required from the EU Commission (or TCA)
- Takeover could be made conditional on such approval
- Early consultation with the EU Commission is recommended

Nationalisation

- CBFSAI itself has express statutory power to purchase shares in a credit institution with the approval of the Minister for Finance
- Express statutory authority would have to be provided for the purchase of a credit institution in the name of the Minister or Government
- Existing legislative provision could not be relied on – draft Bill would need to be prepared
- Would have to provide for compensation for shareholders (possibly with level of compensation worked out subsequently)
- Nationalisation could probably not be effected if the institution was under the protection of the Courts

State Guarantees

- The Minister does not have statutory authority to issue a guarantee
- This would not prevent the Minister announcing his intention to give a guarantee or his intention to protect deposits and then putting in place the necessary legislative measures
- It would be more appropriate to have the necessary draft legislation for a guarantee in place in advance

State Guarantees

- Clarity essential regarding different types of State 'guarantees' that may arise under financial stability event including
  - 'conditional' deposit guarantee as in the case of Northern Rock (may need to distinguish between retail and wholesale deposits)
  - guarantee in respect of CBFSAI liquidity support to distressed financial institution (e.g. in case of low-quality collateral)
  - State guarantee to underwrite a Bank's solvency position (could only be justified in circumstances that otherwise the entire financial system is at risk of collapse)

Legal advice – CBFSAI ELA

- The Minister may request the CBFSAI to consult with him both with regard to the provision of an ELA and the terms and conditions on which it may be provided. The CBSFAI is obliged to comply with such a request
- Seeking to clarify the legal basis for the requirement [from CBFSAI Explanatory Memorandum on ELA] that in order for the CBFSAI to inject liquidity into an insolvent institution a Government guarantee of the institution's liabilities would be required

State Aid

- CBFSAI Liquidity support on commercial terms probably not a State Aid
- Other financial assistance, including guarantees <u>not</u> provided on commercial terms likely to constitute State Aid
- Commission requirements for approving State Aid in such circumstances
- October 2007 Ecofin conclusions invite the Commission to clarify when a major banking crisis might be considered by the Commission as falling within Article 87(3)(b) 9 ("a serious disturbance of the economy")

Emerging Conclusions

- Primary objective is to safeguard public / international confidence in stability of Irish financial system
- It is in the interests of the public that the situation is solved before it enters the public domain in order to prevent contagion
- Whether dealing with 'Big Bang' (SocGen/'Alpha Bank') type scenario or 'Slow Burn' (Nordic countries 1990s)
- Legal advice confirms that proposed framework for crisis resolution is broadly legally feasible
- Review and any necessary reform of DGS a priority given the requirement to ensure that examinership is a credit resolution option
- It is essential that clear roles and responsibilities are identified and the systems are put in place for organising a non-public takeover of a distressed financial institution

Main Policy Issues

- Contact the Competition Authority and the Commission regarding competition implications of courses of action
- Engage with Commission regarding state aid implications
- Clarify crisis resolution responsibilities particularly roles regarding orchestrating a market-based solution
- Prepare draft legislation for enactment as required for:
  - the provision of Ministerial guarantees
  - the nationalisation of a financial institution
- Review of Deposit Guarantee Scheme

Proposed Next Steps

- Department to finalise its proposed approach a paper on crisis resolution
- Seek the views of CB and FR through DSG
- Submit for consideration by MAC / top management
- Policy issues to be submitted for Ministerial consideration / approval
- Crisis manual to be prepared on the basis of policy decisions

Briefing on Financial Stability Issues
7 May, 2008

This note sets out the Irish position and concerns in relation to current financial stability issues. Attached as appendices are notes dealing with: responsibilities in relation to financial stability and origins of current international financial stability.

The key points are as follows:-

International Position

- Since last August, as a result of the "credit crunch" normal wholesale inter-bank lending and funding activities (e.g. securitisation) have at an international level seized up; in essence bank funding is either much more expensive or unavailable at the longer-term maturities that banks need

- While there have been some recent assessments suggesting the environment is set to improve, there are no clear indications that current difficulties will ease significantly for some time.

- Any further marked deterioration in economic conditions in the US or the EU will lead to a worsening of credit conditions.

- An extensive programme of actions is being put in place at EU level to improve financial market conditions and prepare for any risk to financial stability in the EU.

- International central banks, the US Federal Reserve and the ECB / Eurosystem have been very active in seeking to stabilise market conditions.

Situation in Ireland

- The Irish banking system is sound and robust based on all key indicators of financial health (i.e. solvency, liquidity, asset quality, profitability)

- Irish banks have no meaningful exposure to the sub-prime securities which are at the root of the international liquidity crisis overall.

- International sentiment towards the Irish banks is very negative on account of the assessment that the pronounced downturn in the Irish market will undermine their financial position.

- Irish banks are therefore experiencing significant challenges in rolling-over their funding sources.

- In addition there has been intense speculation by hedge funds against specific Irish banks (i.e. Anglo-Irish and Irish Life and Permanent) which on occasion has put very serious downward pressure on their share price which has increased the risk of a run on deposits on those banks.

- Irish banks have been working intensively to exploit any funding opportunities available internationally; as relatively small financial institutions by international standards they have not extensive options

- The Irish banks have build up large reserves of assets that are eligible to be used as collateral against lending by the ECB in circumstances that other funding sources are not available.

- In general, Irish banks are reluctant to access this funding owing to the risk that this will send a negative signal to the market and lead to the shutting down of other credit lines.

- A domestic shock (e.g. failure of a major property developer or very sharp further falls in property prices) would have a major negative effect on the financial position of the Irish banks on a systemic basis.

Contingency Planning

- The Financial Regulator and the Central Bank have been working very closely with the banks to monitor their liquidity position on an ongoing basis and seek to identify risks to their sustainability at the earliest possible stage.

- The Department of Finance, Central Bank and Financial Regulator are in very close contact to exchange information on developments and advance contingency planning arrangements for dealing with the emergence of serious difficulties in any specific institutions or the banking system as a whole.

Primacy of market solutions

- Responsibility for managing current issues affecting individual institutions and developing strategic options for responding to the market environment rests with the boards and senior managers of the institutions concerned.

- The CEO of the FR has been meeting with the boards / top management of some financial institutions to impress upon them the need to be prepared to examine all options to pre-empt the emergence of any difficulties.

- State intervention is only appropriate in circumstances that problems in an individual institution run the risk of creating systemic difficulties in the national financial system as a whole.

Detailed information note attached.

Irish Financial System

Irish banks currently meet all the conventional measures of financial health - solvency, liquidity, profitability, asset quality. Their strong performance over recent years provides a good cushion to deal with the current financial market environment.

However, Irish banks cannot remain immune indefinitely to the virtual closure of money markets and are subject to specific pressures and stresses – over and above those applying more generally internationally - owing to wide-spread international concern regarding the exposure of Irish banks to the property market and in particular commercial lending. This has been demonstrated by heavy and intense speculation against Irish banks by hedge funds at times over recent months – share prices of individual banks had declined by 40-50% over the past twelve months and have been subject to particular volatility at times (e.g. share price of Irish banks fell between 5% and 15 % immediately after the announcement (17 March) of the collapse of Bear Stearns), while the share prices have recovered somewhat since, they remain significantly below their 2007 highs.

In the money markets, the price of 3 month money rose 34 basis points in March and a further 13 bp in April, such that funding is now significantly above its 'normal' price. Against a background of continuing tightening in money markets and particular concerns by international investors, the funding environment for Irish banks has disimproved further in recent weeks and there is evidence that some previously established credit lines in the US are being restricted. Notwithstanding the continuing positive statements by Government and the CBFSAI vouching for the strength of the Irish banking system, international investors are being influenced by the views expressed by some domestic commentators.

Prognosis for the International Financial Situation

Financial market conditions remain very difficult, the international financial sector remains under considerable stress and there is no reliable indicator that any sustained improvement will be achieved for some time. Reports are now occasionally appearing in the media of the 'bottom having being reached' in the present credit crunch, but these tend to be triggered by publication of economic statistics that are less bad than expected or unexpectedly good results (again less bad than expected) from individual financial institutions.

An example of such reports arose in the context of the publication of the UK's Financial Stability Report. The Bank of England, at the publication of the FSR, pointed out raising US sub-prime defaults had triggered a broad-based repricing of risk and deleveraging in credit markets. It pointed out that the adjustment to credit markets had proved more prolonged and difficult than anticipated, such that prices in some credit markets are now likely to overstate the losses that will ultimately be felt by the financial system and the economy as a whole. The Bank stated conditions should improve as market participants recognise that some assets look cheap relative to credit fundamentals. However, having made this point, the Bank of England noted sentiment remained weak[1], which had caused it to announce a special scheme to

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[1] In the near term, tight funding conditions mean banks are vulnerable to adverse news and rumours, as highlighted by the run on Bear Stearns in mid-March, tight credit conditions can be expected to lead to a pickup in defaults among vulnerable borrowers, including some households/ parts of the commercial

improve the liquidity position of the banking system and to increase confidence in financial markets.

Notwithstanding occasional positive reports, overall, share prices in the financial sector remain volatile, wholesale inter-bank lending is only taking place over short time horizons, and financial institutions are experiencing major difficulties in securing funding for longer time periods. A high degree of caution and conservatism and hoarding of cash is evident across the whole of the international financial sector. A number of major international financial institutions have had to rebuild their capital position owing to the scale of losses they have experienced.

In Summary:

- The concerns that initially led to credit markets seizing up last August are persisting.
- Major financial institutions continue to disclose major write downs.
- Estimates of the total losses by authoritative international bodies continue to increase.
- International initiatives and in particular the activities of the Federal Reserve and the ECB / Eurosystem have helped in important respects to stabilise financial market conditions at particular times.
- International efforts to resolve the root causes of the crisis for example by promoting increased transparency or new valuation approaches are yet to bear fruit.

Funding Position of Irish Banks

As a member of the euro area, access to normal ECB funding is a major benefit for Irish banks owing to the wide range of eligible collateral against which they can borrow funds from the Eurosystem. Irish banks have over recent months built up large reserves of ECB eligible collateral. In general, however, they have been slow to access funds from the ECB owing to the view that this would contribute to negative investor sentiment but this buffer is available to them if credit market conditions were to deteriorate further.

In circumstances that the financial system cannot access funds from the wholesale market, the only viable commercial strategy is to significantly restrict their lending activities. This is already apparent in terms of the withdrawal of particular lending products (e.g. 100% mortgages) from the market and the introduction of much tighter lending criteria. A sharp retrenchment in lending has the obvious potential to impact adversely on the economy and increases the risk of loan defaults.

The Central Bank and Financial Regulator are working closely with the domestic financial institutions to monitor their liquidity position on a weekly basis, identifying where significant funding pressures may emerge in the future.

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property sector, and financing difficulties could emerge in some emerging markets, including countries in Central and Eastern Europe with large current account deficits

The following points set out, in summary form, information regarding domestic financial stability planning arrangements:-

- The Central Bank is liaising with the major domestic banks at CEO level to explore the options that may be available for mutual support between the Irish banks in a crisis situation and to respond to any problem in small institutions in a collaborative fashion.

- The CEO of the Financial Regulator is meeting with the top management / boards of institutions to discuss business strategies and market-based options for dealing with difficulties that may arise in meeting funding requirements.

- The NTMA has placed some deposits with most of the main financial institutions. They are keeping this under review and will liaise with the Department and the CB/Financial Regulator as necessary.

- The NTMA is also exploring engaging in secured lending on the basis of non-ECB eligible collateral.

- The Central Bank is examining on an ongoing basis the options available to it in providing funding to Irish financial institutions.

- A standing group is in place composed of senior representatives of the Department of Finance, the Central Bank and the Financial Regulator to consider any domestic financial market issues.

EU Actions

A broad programme of actions (set out in a 'Roadmap' agreed by EU Finance Ministers in October, 2007) is being undertaken at EU level in response to financial market conditions. This includes work on improving transparency of complex financial instruments, valuation standards, the prudential framework, risk management, supervision and market functioning, including the role of credit agencies. A Memorandum of Understanding has recently been agreed at EU level dealing with the principles and arrangements for dealing with a crisis affecting any major EU cross-border bank.

7 May, 2008

Appendix 1

Background on

Responsibilities in relation to financial stability

The Minister for Finance's overall responsibilities relate to policies for maintaining macroeconomic stability, the adoption of fiscal strategies that support long term budget sustainability, and promoting a competitive and efficient market in financial services with a strong focus on the consumer.

The **Central Bank and Financial Services Authority of Ireland** is the institution charged with contributing to financial stability in Ireland, under both domestic and EU legislation. The organisation consists of two component entities: the Central Bank and the Financial Regulator, each with its own responsibilities. The roles are complementary and there is close co-operation in relation to financial stability issues:

- The **Central Bank's** statutory[2] duty specifies that "the Bank has ... the objective of contributing to the stability of the financial system"[3] Its responsibilities for financial stability relate to the surveillance of the strength and vulnerability of the overall economy and financial system (i.e. its focus is at the overall macro level).
- The **Financial Regulator's** remit includes the authorisation, prudential supervision and surveillance of the financial soundness of individual institutions (i.e. it is focused at the more micro level of individual institutions).

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[2]Central Bank Act, 1942 (as amended), Section 6A(2)(a)

[3] The Central Bank is also covered by the mandate of the ESCB, which requires the European Central Bank and national central banks to contribute to financial stability in the euro area. This, therefore, requires that the Bank contributes to financial stability, both in Ireland and, as far as is practicable, elsewhere in the euro area, through its involvement in international fora.

Appendix 2

<u>Background note on origins of current financial stability concerns</u>

Financial markets have been in turmoil since August 2007, amid a sharp decline in investors' appetite for credit risk. The turmoil was triggered by financial losses due to defaults in the US market for sub-prime (i.e. low credit-quality) mortgages. These losses have been transmitted rapidly across the global financial system via the markets for complex financial instruments. The opacity of these instruments, combined with credit risk dispersion, made it difficult to identify the exact size and location of losses, thereby undermining investor confidence in financial markets more generally. Losses to-date by major financial institutions has been estimated at circa $300 million, with estimates of eventual losses put in a range of $500 million, to (increasingly) $1billlion. Major US and EU financial firms (E.g., Citigroup, UBS, Bear Stearns) have had major write-offs, resulting in a need for these firms to raise fresh capital form investors and Sovereign Wealth Funds, or in the case of Bear Stearns, rescue by the US Federal Authorities.

The major consequence for the Irish banking system has been the profound disruption of money markets. This has made access to funds very much more difficult, increased in the cost of funds and 'shortening' of the funding periods (i.e. funding is increasingly available only on a weekly/monthly basis as compared to previous periods of three or six months or longer). Because of the difficulties in money markets, there have been considerable interventions by major central banks into the interbank markets to restore orderly conditions by providing liquidity.

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Establishment of a Domestic Standing Group (DSG) – roles, responsibilities and outstanding issues.

Scoping Paper arising from meeting 10 January 2007

Introduction

This paper follows a meeting between the Central Bank and Financial Services Authority of Ireland (CBFSAI), the Financial Regulator and the Department on Finance on 10 January 2007.This scoping document outlines what the function of a DSG is, the roles and responsibilities of the various parties and any questions that need to be addressed to progress the establishment of the DSG, consistent with the guidelines set out by the EFC/FSC.

What is a DSG?

The EFC/FSC describe the role of a DSG as follows:
The role of a DSG is to ensure full and timely information exchange and evaluate, prevent, and if necessary, manage potential systemic problems. A DSG should regularly evaluate and assess the systemic soundness of, and the risks to, the domestic financial markets. It can also be involved in the management and evaluation of domestic stress tests as well as regional, EU-wide or other types of simulation exercises, as well as function as the focal point of information exchange, planning and management on potential systemic financial problems, both nationally and with similar groups in other Member States.

The EFC/FSC have laid down a list of measures that we are required to implement with respect to our domestic financial stability framework. These measures with deadlines are:

o Establish Domestic Standing Groups (DSG)	July 2007
o Develop national contingency plan	January 2008
o Put together, where appropriate, institution specific interest groups for cross border financial institutions	No date given
o Carry out a crisis simulation exercise at national, regional or interest-group level	January 2008
o Stress test by central banks and supervisors	July 2008

The Department of Finance's current assessment of the primary function of a Domestic Standing Group is to facilitate information exchange and communication between the Department of Finance, the Central Bank and Financial Services Authority of Ireland and the Financial Regulator in relation to safeguarding financial stability. It is envisaged that the DSG will oversee financial stability planning between the three parties. The DSG's role must be underpinned by existing legal roles and responsibilities of the three organisations in their respective areas. It also requires the drawing up of an agreed Memorandum of Understanding (MoU) between the Department of Finance, the Financial Regulator and the CBFSAI.

For information a summary of the UK structures for crisis management is attached as an Appendix to this paper.

Legal Responsibilities:

At the onset it is important to ensure that the role and terms of reference of the DSG are consistent with statutory responsibilities of each of the parties under the current legal framework.

CBFSAI

The CBFSAI is responsible for contributing to the overall stability of the Irish financial system. This mandate comes from the Central Bank Act 1942, as amended, which states that "the Bank has......the objective of contributing to the stability of the financial system" and the mandate of the European System of Central Banks which requires the CBFSAI to contribute to financial stability in the Euro area.

The CBFSAI's responsibility to contribute to the overall stability of the financial system involves:

- ensuring the stability of the monetary system, monitored as part of the CBFSAI's Eurosystem monetary policy function. As necessary, the CBFSAI must take action in the market and deal with day-to-day fluctuations in liquidity
- ensuring the smooth operation of the payments system, advising the Minster for Finance and the Financial Regulator of any significant issues in the system and promoting improvements in the financial sector infrastructure increasing the efficiency and effectiveness of the sector
- providing an overview of the financial system, advising on the implications for financial stability of developments in the domestic and international markets and payments systems and assessing the impact on monetary conditions of events in the financial sector.
- identifying developments (macro- or micro-prudential, where appropriate) that could endanger system as a whole and advising on such issues, including publishing an Annual Financial Stability Report that reflects the views of the CBFSAI and the Financial Regulator.
- in exceptional circumstances, undertaking official financial operations in order to limit the risk of problems affecting particular institutions spreading to other parts of the financial system

Financial Regulator

The Financial Regulator is responsible for contributing to the maintenance of proper and orderly functioning institutions and exchanges and protecting consumers of financial services products. The Regulator supports the CBFSAI's objective of financial stability by carrying out these functions. The mandate from these functions comes from the Central Bank Act 1942, as amended.

The Financial Regulator's responsibilities are:

- the prudential supervision of banks, building societies, insurance companies, stockbrokers, exchanges, investment firms, retail intermediaries, credit unions and collective investment schemes
- providing advice, information and assistance in relation to the CBFSAI's functions

Department of Finance:
The role of the Department of Finance involves:

- promoting financial stability generally and a competitive and efficient market in financial services, with a strong focus on the consumer.
- ensuring that the financial services regulatory structure continues to meet the Government's consumer protection, competitiveness, and financial stability objectives.

<u>Issues for Discussion:</u>

Overall Role

1. Do any legal/accountability issues arise from the DSG's proposed functions as set out by the EFC/FSC? Are its roles and responsibilities aligned with the existing legal framework?

2. Should the DSG's role primarily relate to overseeing the coordination of emergency planning arrangements between the three bodies?

3. What role could the DSG play in relation to the functions highlighted by the EFC/FSC of "regularly evaluate and assess the systemic soundness of, and the risks to, the domestic financial markets" and the "management and evaluation of domestic stress tests"?

4. The Central Bank and the Financial Regulator have a Financial Stability Committee and a joint MoU already in place in order to facilitate co-operation on the issue of financial stability. Where does the DSG fit in with this Committee? Does it fulfil a similar function on a tripartite basis?

5. There are a number of groups and public sector structures responsible for contingency planning arrangements in different emergency scenarios, e.g. the Office of Emergency Planning in the Department of Defence. Is the proposed DSG the appropriate structure to deal with the financial stability dimensions of these broader emergency planning issues (e.g. maintenance of the payments system)? What issues arise with respect to the DSG's engagement with these other emergency planning structures?

Operational Issues

6. What is the appropriate level for the membership of the DSG and what organisation should chair it in view of its intended role?

7. How would the DSG interact with the three organisations participating in the DSG on both a routine and a crisis management basis?

8. What should the DSG's working methods, work programme and priorities for 2007 be?

9. How should the DSG go about its role of preparing an agreed Memorandum of Understanding between the parties?

10. What are the key informational requirements for the DSG to enable it to fulfil its role effectively?

11. Who are the key personnel in each organisation whose work needs to feed into the work of the DSG?

Liaison

12. What level of public disclosure of the work of the DSG is appropriate? In this context, what legal/confidentiality issues arise?

13. What issues might arise in relation to possible engagement with the private sector (e.g. payments system)?

14. Is consideration required of any of these issues at Board, Regulatory Authority or MAC level?

Proposed Next Steps

The next steps required for the establishment of the DSG by July 2007 and the meeting of the other targets set by the FSC are:

- the drafting of a tripartite MoU between the Department of Finance, CBFSAI and the Financial Regulator to establish the DSG (by July 2007)
- the clarification of the legal position of the three parties with respect to financial stability and financial crisis management (also by July 2007)
- prompt updating of operating manuals in the Department of Finance, CBFSAI and the Financial Regulator, detailing the policies and procedures should a systemic crisis occur. (contingency plan in place by January 2008)
- arrangement of a tripartite crisis simulation exercise (must take place by January 2008)

Appendix
UK Model of a DSG

Since the meeting of 10 January, the Bank of England has recently given a presentation in Dublin on Financial Crisis management. This presentation touched on some of the issues outlined above, particularly the level at which a DSG operates. The UK has a tripartite MoU in place between the Bank of England, FSA and the Treasury. There is a tripartite Standing Committee that deals with issues affecting financial stability. It is composed of the Chancellor (Chair), the Governor of the Bank and the Head of the FSA. This group of principals meet only when required, while monthly meetings take place at Head of Function level. In the case of a crisis, a Joint Crisis Committee is formed. This would be at Head of Function level for each party. Relevant information, etc is fed from the relevant sections of the three organisations through the Joint Crisis Committee to the Standing Committee. It is the Chancellor, the Governor and the Head of the FSA who have to make the relevant decision in a crisis. Business Continuity Planning (Operational Crisis Management) is also deal with by the Standing Committee. However, the responsibilities of the organisations are different in the case of an operational crisis, which would have, by its nature, more parties involved, e.g. the police, Home Office, etc.

6a.

(24)

Draft Initial Work Programme of the Domestic Standing Group on Financial Stability

The proposed work programme for the DSG will include ~~involve~~:

- overseeing the prompt updating of operating manuals in the Dept of Finance, CBFSAI and the Financial Regulator, detailing the policies and procedures to apply should a systemic crisis occur. The EU FSC/EFC requirements on domestic financial stability arrangements require these contingency arrangements to be in place by January 2008;
- conducting a tripartite crisis simulation exercise and reviewing the outcome of this exercise. To comply with the EFC requirements this also must take place by January 2008;
- making arrangements for developing general principles to guide the resolution of a financial crisis, taking account of EU work in this area;
- examining the role of the DSG in responding to operational disruption of the financial system and business continuity arrangements for the financial system, particularly in the context of the EU's initiative in the area of critical infrastructure protection; and
- examining the implications for information exchange between the parties of FOI legislation and the professional secrecy provisions of the 'Supervisory Directives' as defined in the Central Bank Act 1942 as amneded;
- examining the impact of Company Law provisions relating to insolvency on potential crisis management operations.

12C

Lonergan, Ciara

From:	Beausang, William
Sent:	16 November 2007 11:01
To:	Manley, Michael
Cc:	Nolan, Kevin; Lonergan, Ciara
Subject:	Agenda for today's DSG meeting

Could you compile something to the effect

- FSR - update on response / any follow up issues
- update on financial market environment and situation of Irish banks
- update on planning for simulation exercise
- update on contingency planning

FIN 9/105/PM/003

6

Confidential

1. Beausang (To see)
2. Tánaiste

CBFSAI Assessment of Financial Market Developments
16 November 2007

The attached report sets out the most recent assessment of the Central Bank and Financial Services Authority of the current situation presented at the Domestic Standing Group meeting on 16th November. The main points arising were as follows:

- Funding availability for Irish banks is tight. This situation is likely to be exacerbated by:
    - End-of –year pressures as banks seek to close off positions.
    - A number of Irish financial institutions have significant 'roll-over' funding requirements arising from the beginning of next year. **If the present market conditions persist, as expected, into 2008 there is an increased risk of liquidity issues arising for Irish banks.** The Irish banks are therefore engaged in contingency planning (incl. restructuring assets to provide collateral, restricting lending growth) to meet future funding needs.

- While Irish banks have, to date, absorbed the increased cost of funding there are already indications they are tightening credit standards, potentially impacting on economic performance.

- There is anecdotal evidence that the change in the financing environment and restriction of lending is impacting on the property development sector.

- Irish banks share prices have continued to fall and have lost between 30% and 50% of their value since the start of 2007 because of negative investor sentiment regarding Irish banks and their exposure to the Irish property market.

- Speculation against Irish financial institutions is an important element of the overall financial landscape, underlining the importance of **highlighting the inherent strengths of the Irish financial system and economy.**

The Department will continue to liaise with the CBFSAI, which in turn maintains high level links to the Irish banks and are monitoring the position very closely.

Michael Manley
28 November 2007

Confidential

CBFSAI Assessment of Financial Market Developments
16 November 2007

The level of activity in the interbank lending market remains low

In the euro area, the level of lending activity in the interbank market remains low by normal standards. There is good availability of funds at short maturity (1 month), but very limited at longer maturities, e.g. 3 month. While Irish banks are continuing to meet their funding needs in a difficult market environment in November, there are recent indications that the funding environment has deteriorated in particular in the unsecured interbank market. A covered bond issue by one of the major banks week commencing 19 November will be important in testing the appetite for Irish-economy based risk in the international marketplace.

Interbank rates remains high

Interest rates remain above the target 4% rate, particularly in the 3 month market, standing at 4.584% [Friday, 16 November rate], down from a peak of 4.795%. at 2 Oct. The 3 month rate is an important determinant of retail lending rates for the Irish banks – to date the banks have absorbed the increased cost of funding, but as this higher cost continues it puts upward pressure on lending rates charged to individuals and business. There are already indications that Irish financial institutions are tightening credit standards on account of the higher funding costs. This 'credit rationing' has the potential to impact on economic performance owing to the reduced availability of finance for investment and consumption.

"End-of year premium" will increase costs of accessing liquidity in the interbank market but ECB can inject liquidity into the market if required

At end-year there is usually a premium for cash as credit institutions close off their positions. In the current disrupted financial market conditions this "end-of-year premium" adds to the premium already present. Available liquidity in the market place is being reduced as major international banks hoard liquidity to meet their own requirements including to meet losses on sub-prime investments and to take on balance sheets exposures in conduits and SIV that were previously off balance sheet. In view of the scale of expected sub-prime losses against those currently disclosed, uncertainty remains in the market in relation to where losses are located – hedge funds are a source of concern in this respect.

In such circumstances second-tier banks (such the main banks in Ireland) are subject to greater pressure to secure funding. This is creating increased pressures on domestic financing institutions to restrict their lending activities or offering finance on stricter terms in order to support their liquidity position.

The ECB is continuing to prepare to intervene as required to provide liquidity to the market. However, this funding is provided at above market rates and is less attractive to banks which have mange their liquidity while minimising the cost of funds. Where banks have good quality assets as lending collateral, they are using it to access market funding at more competitive rates. This suggests that any increased access to ECB liquidity is evidence of increased financial stress.

Irish banks are managing their funding requirements with increasing difficulty

Banks are reporting to the CBFSAI that they are managing their liquidity, but that this is increasingly difficult given the tightness of liquidity in the money markets and the price of funds. As available funding is increasingly shorter term, this is compressing the maturity profile of the banks' funding. In circumstance of continuing credit market difficulties, this increases funding pressures in Irish banks. There are some indications that Irish banks are being subject to more refusals in the unsecured interbank market on account of negative international sentiment regarding the Irish banking sector and the Irish property market generally and events such as the high-profile solicitor cases and the recent difficulties in ISTC. As a small economy with a peripheral presence in international financial markets, large institutional investors may be inclined to by-pass the Irish market in a situation where market sentiment regarding the financial sector and the property market has been negative.

2008 will present particular challenges. Banks are currently executing contingency funding arrangements

A number of Irish financial institutions have significant funding requirements arising from the beginning of next year. In advance of this they are taking a number of steps to prepare for an eventuality that this funding rollover takes place against the backdrop of a resurgence of difficulties in international credit markets. These include steps to build up collateral requirements through, for example, securitisation transactions that will facilitate borrowing from the ECB if they are not able to access liquidity from the usual channels in those circumstances. Other measures that are available to Irish banks to prepare for this eventuality is to restrict lending growth. According to the FR there is anecdotal evidence that the change in the financing environment is impacting on the property development sector as projects are postponed (which for major projects alleviates somewhat funding pressures on the banks). The quality of assets secured on speculative development land is a particular focus of attention for financial institutions at this time.

Internationally, on a day-to-day basis longer term (i.e. 6 month and 12 month) funding is being rolled over into shorter-term (i.e. 3 month) debt. This process gives rise to a heightened risk of a major demand-supply balance on an ongoing basis. **Therefore, notwithstanding contingency measures adopted by banks to enhance their access to liquidity if the present market conditions persist, as expected, into 2008 there is an increased risk of liquidity issues arising for Irish banks.**

International investor views and the share price of Irish banks have continued to fall

Irish bank share prices have continued to fall and have lost between 30% and 50% of their value since the start of 2007. Notwithstanding the posting of good results by Bank of Ireland on Wed. 14 November, its share price fell a further 6% that day, at one point falling by 8%, perilously close to the 9% figure at which trading in a share is temporarily suspended. The decrease in value of Irish banks shares has been greater than in other countries. There is a general discount in the value of Irish banks as there is a perception internationally that they are exposed to the property market – reinforced in a 7 November report from Merrill Lynch setting out a negative perspective on the Irish banking sector because of property exposures. Possible hedging Intense speculation against Irish financial institution is an important element of the overall financial landscape including the activities of hedge funds and the possible hedging of exposures of commercial property bonds issued by Irish property developers through short-selling of Irish bank stocks. In the present uncertain climate, any negative event/comment is subject to amplification in international markets impacting on the share price of banks and the availability of funding. **Taking-up appropriate opportunities to highlight the inherent strengths of the Irish financial system and economy are therefore considered to be very important.**

Timeframe for normalisation of market situation

The view is increasingly being expressed by commentators, analysts and individual financial institutions that the current market disruption will take an extended period (i.e. up to 2 years) to resolve. At the same time there is continued uncertainty regarding the scale of losses on investments associated with US subprime mortgages with some estimates now a multiple of initial forecasts of €100bn. Developments in the US property market are expected to influence strongly the future direction of these estimates

The major risks for financial markets are a US recession impacting in particular in the US property market which leads to a degrading of assets backed by non-subprime mortgages or large losses by a major hedge fund leading to a forced sales sub-prime backed assets.

Contingency Planning Arrangements

The Central Bank and Financial Regulator continue to liaise with the Irish banks closely at CEO level and are monitoring the position very closely. The banks in turn are working intensively to implement contingency arrangements to meet their liquidity requirements.

(4)

WPR
1. Mr Ryan to see
2. Ms Lonergan

To:

1. Mr. K Nolan
2. Mr. P Ryan WPR
3. Mr. W Beausang ✓

WPR Could you email to CB IFR participants for any final changes. WB 19.3

cc: Kevin Cardiff

WB 21.3

Re: Initiating Domestic Standing Group for crisis management / financial stability – meeting 6 March 2007

Please see attached note which outlines the main points arising at a meeting between Department of Finance, Central Bank and Financial Services Authority of Ireland and the Financial Regulator, where the establishment of a Domestic Standing Group was discussed.

Ciara Lonergan

Ciara Lonergan
19th March 2007

Note of Meeting between Department of Finance, Central Bank and Financial Services Authority of Ireland (CBFSAI) and Financial Regulator re initiating Domestic Standing Group for crisis management/financial stability
6 March 2007

Attendance: CBFSAI:		Tom O'Connell
		Tony Grimes
		Ann Marie McKiernan
	Financial Regulator:	Con Horan
	Department of Finance:	William Beausang
		Phil Ryan
		Ciara Lonergan

This note records the main points arising

1. **Role of DSG**
It was agreed that the role of the DSG is to co-ordinate information sharing between the CBFSAI, the Financial Regulator and the Department of Finance within the framework of the current legal powers of each authority. The existing roles and responsibilities of all three authorities will remain unchanged. The DSG will gather together information and will be briefed on work on financial stability issues being undertaken in the three authorities. The DSG will operate at a macro level overseeing the financial stability environment generally and appropriate planning arrangements. The DSG will also plan and manage crisis simulation exercises. It may be appropriate for the DSG to set up working groups examining for example in more detail relevant BCP/critical infrastructure issues (see point 3 below)

2. **Interaction of DSG with the existing financial stability framework**
The DSG should dovetail with the existing stability framework, without overlapping with current arrangements. The Financial Stability Committee of the CBFSAI and the Financial Regulator examines financial stability at a macro level. There may be "added value" by the inclusion of the Department of Finance perspective, for example the economic and tax side may have useful information to input into the assessment of the DSG. The meetings of the DSG could align with FSC meetings to facilitate the information sharing role of the DSG.

3. **Business Continuity Planning (BCP)/Critical infrastructure Protection (CIP)**
The CBFSAI's current work on BCP has two strands. The first strand is internal BCP for the CBFSAI's operations. This is currently being developed with the aim of having all systems replicated in the Sandyford Currency Centre. The second strand involves dialogue with industry in relation to BCP in the financial sector. The CBFSAI is currently talking to the IBF, who have been working on BCP issues independently. The CBFSAI does not become engaged at a detailed level with this type of BCP but needs to be assured that appropriate BCP is in place in the industry. Discussions carried out with the IBF have looked at the main issues: liquidity, payments system and broader "cash" issues.

The EU proposals for CI protection relate to European Critical Infrastructure (ECI) which is "those infrastructures, the destruction or disruption of which would ***affect two or more member states*** or a single Member State if the critical infrastructure is located in another Member State." In relation to the financial infrastructure in Ireland the key ECI is the Target payment system
With respect to the DSG, the DSG's role in BCP/CIP needs to be explored in detail. The extent to which a problem with the financial infrastructure is an issue for the DSG will need to be scoped out – the key issue is whether an infrastructural problem will lead to systemic problems. It will be important in examining this issue to also look at the probabilities of different scenarios and their impact on the financial system overall.

4. **Crisis Vs Non-Crisis role of DSG**
It is important to distinguish between the appropriate role of the DSG during a time of crisis and during non-crisis times. Generally its role will be as described in point 1 above. In a crisis situation the DSG's role will be to advise the principals in each authority. As in a non-crisis situation, the roles and responsibilities of each authority are without prejudice to the exercise of statutory responsibilities by the constituent authorities. The majority of work required for any support operation would take place within each authority with the DSG facilitating information sharing and co-operation between the organisations.
The benefit of the DSG in a crisis situation is that its members will have developed their familiarity with the procedures and issues arising in such a situation, through briefing and simulation exercises. These simulation exercises will help clarify the role of the DSG in a crisis situation. Some further examination of the DSG's specific role in a crisis may be required.

5. **Membership of DSG**
The general business of DSG will be undertaken at the level currently attending these preliminary meetings, with representatives from the CBFSAI, the Financial Regulator and the Department of Finance.
In addition to the three organisations who make up the DSG, in times of crisis the DSG may need the assistance of other public authorities (e.g. the Office of the Attorney General, the Department of Enterprise, Trade and Employment and the NTMA). The DSG may have to ensure that there is a contact point in each organisation available as required. This may be included as part of the three authorities' operational manuals rather than outlined in the MoU governing the DSG.

6. **Public disclosure/confidentiality**
The European Central Bank has tended to say very little about financial stability planning/financial crisis management arrangements. The MoU on crisis management and the tripartite cross border MoU between Ministries of Finance, Central Banks and Authorities are not published. The CBFSAI has tended to follow the ECB's example and has not published material on financial crisis management.
Practice on whether DSG and financial crisis arrangements are publicised varies from country to country in the EU. Those that have published information (e.g. UK, Sweden) have tended not to be in the Euro system

although the Benelux countries, particularly Belgium, have a significant amount of information in the public domain.

7. **Future EU Developments**
The work of the EFC Ad hoc Working Group on financial crisis management may lead to further requirements for Member States in this area. The Group's interim report is to be presented at the EFC meeting in March.
Financial stability/financial crisis management requirements may be raised at the EFC Financial Stability Table in April and September.

8. **Next Steps: Memorandum of Understanding**
A key priority for the DSG is the preparation of a draft MoU outlining the composition of and role of the DSG and the member's roles and responsibilities, highlighting the fact that the establishment of the DSG does not affect the existing legal framework. The Department of Finance will draft a preliminary MoU to be circulated to all parties and arrange bilateral meetings as required. The agreed draft would then be discussed at a meeting after Easter and the preliminary agreed draft could then be submitted for approval in the Department of Finance, the CBFSAI and the Financial Regulator.

____

Ciara Lonergan

Executive summary

Ireland has continued its exemplary economic performance, attaining some of the highest growth rates in the OECD. After a remarkable decade, per capita income has caught up with and overtaken the EU average. Further progress will require strong productivity growth and continued increases in labour supply. These challenges are familiar to most OECD economies. But it also faces some issues that are less common: it is going through a transition phase in upgrading its social services; infrastructure levels need to catch up with the boom in activity and population that has occurred over this period; and it has to manage some sizeable macroeconomic risks.

Maintaining high rates of productivity growth. *As Irish activity comes to rely less on foreign firms and more on home-grown services, productivity gains will become harder to achieve. The main areas where policy could make a difference in sustaining productivity growth are:*

- *Boost competition. There are too many sectors where producers are shielded from competition, raising prices and stifling growth. Reforms are needed in the electricity and telecom sectors, and unnecessary restraints in services such as law, pharmacies and the pub trade should be removed. In the retail sector, the government's decision to abolish the Groceries Order is welcome.*
- *Improve education. Funding is still an issue in universities. One option is to re-introduce tuition fees, but backed by an income-contingent loan scheme. In secondary schools, the key challenge is to target resources on students who are struggling.*
- *Encourage innovation. The science framework needs to improve before public spending is increased further. The many funding agencies could be amalgamated or better co-ordinated; public support could shift towards market-driven measures; and resources should not be spread too thinly.*
- *Upgrade infrastructure. Rigorous cost-benefit analysis of infrastructure projects, including those in the ten-year transport plan, should play a greater role in decision-making than has been the case in the past. Moreover, an increasing number of projects should be financed by users.*

Boosting labour supply. *An important option for boosting labour supply is to raise female participation. Expanding day-care for infants and out-of-school care for children will help. From the point of view of labour market participation, childcare supports such as the new Early Childcare Supplement should be linked to employment status or made conditional on actually using formal childcare. A mutual-obligations approach for sole parents would help reduce child poverty by assisting parents to get a foothold in the labour market. As regards older people, work incentives in the public-pension and welfare systems could be improved. Migrants will also continue to play an important role in alleviating labour supply bottlenecks. The attractiveness of Ireland for immigrants will be influenced by the overall price level (including house prices) and the quality of public services.*

Macroeconomic risks are high. *As one of the OECD's more open economies, Ireland is particularly exposed to external risks. But it also faces domestic risks. House prices may have overshot fundamentals to some extent, although this does not imply that they will fall significantly; and house building will eventually ease. A soft landing is the most likely scenario but a sharper fall cannot be ruled out. Hence, the government needs to leave plenty of breathing space by balancing the budget or running a surplus, curtailing tax breaks and pushing ahead with public management reforms to get better value for money from public expenditure.*

normally buy a house, the average number of people per dwelling has fallen but is still high by OECD standards and there has been significant immigration. Even so, most indicators – including econometric models – suggest that house prices may have overshot their equilibrium level to some extent.

While house prices may be overvalued, this does not imply that they will fall. The housing market is not symmetric. Prices, construction activity and turnover all surge during a housing boom. After the peak, however, people prefer to take their house off the market rather than sell at a loss. The most likely scenario therefore is that prices will stabilise (or perhaps fall *slightly*), house building activity will fall back, turnover will decline sharply and Ireland will have a flat housing market for several years. By the end of that period, incomes should have grown by enough so that fundamentals catch up with actual prices, and the next cycle can begin.

Although this "soft landing" scenario is the most likely one, there are alternatives on the upside and the downside that could have large macroeconomic implications. On the upside, the market may not level off endogenously and prices may continue to rise. In this scenario, events could develop into a significant over-valuation with serious macroeconomic imbalances. Although short-term interest rates are back on the way up, the increase is likely to be fairly mild. It is therefore difficult to see what would prompt a slowdown in housing demand in the short term. While the enormous increase in supply over the past three years should take some pressure off prices, international experience shows that this process is rarely smooth and orderly – see Ahearne *et al.*, 2005). Obviously, the more that houses become over-valued, the greater the chances of a subsequent slump. The experiences of Japan, Sweden and Finland show that the aftermath of an asset price bubble can be serious and long-lasting. Now that monetary policy is set by the European Central Bank, the Irish government has few levers that could be used to avoid this scenario unfolding. But it can alter housing taxation and, as shown in Chapter 7, Ireland's tax system is more favourable to housing than that of most other OECD countries.

The second possibility is that house prices fall by a significant amount over the next few years either because the economy gets hit by a negative shock or because houses are more over-priced than commonly thought. It is difficult to assess how big an impact this would have on consumption because the economy has changed so much recently and a lack of information on household finances means that little is known about the marginal propensity to consume out of wealth. International evidence suggests that the consumption impacts are higher in countries such as Ireland and the United Kingdom which have high home ownership rates, variable rate mortgages and high loan-to-value ratios (Catte *et al.*, 2004). Estimates of the short-run marginal propensity to consume out of housing wealth range from virtually zero in France, Italy and Germany to 0.08 in the United Kingdom where variable interest rates and mortgage equity withdrawal generate a considerable amount of over-shooting, though mortgage equity withdrawal is not common in Ireland.

Residential construction is also a risk

Even if prices level out, a decline in house building may have large macroeconomic consequences. The rate of house building has averaged 79 000 units per annum for the past two years. This is well above the medium-term sustainable rate of around 50 000 to 60 000 units (Table 1.5), reflecting demand due to very strong immigration and the desire for second homes (including holiday houses and investment properties). With housing

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OECD Economic Surveys: Ireland

Chapter 7

The housing boom

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

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

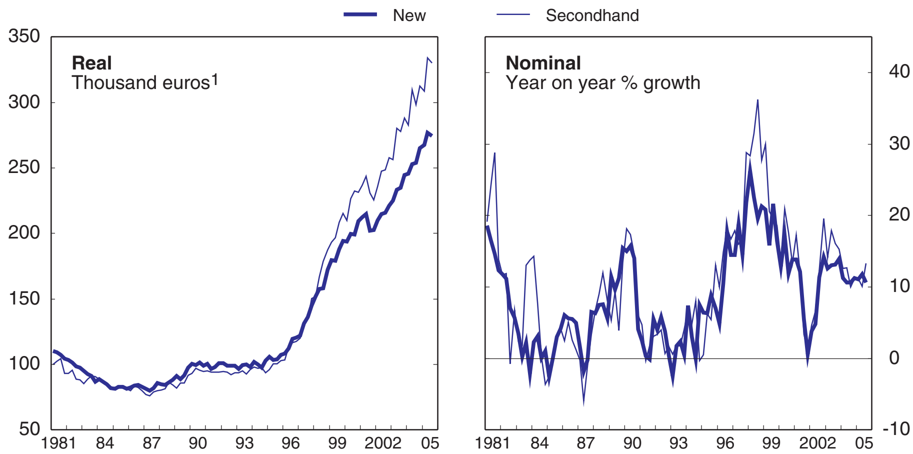
This chapter argues that *most* of the increase in Irish house prices is justified by the economic and demographic driving forces. It should be remembered that in 1993 the average Irish house cost a mere € 75 000, which was extraordinarily low for a European country. Since then, remarkable growth in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

Forces driving the housing market

Ireland's house prices have risen dramatically since the mid-1990s. From 1995 to 2005 the price of second-hand houses more than tripled in real terms (Figure 7.1, left panel). House price inflation eased temporarily in 2001 but it has reignited since. Compared with other countries, the Irish housing boom has been extraordinarily vigorous: both in real and nominal terms the increase in house prices since the mid-1990s has been the highest in the OECD, with the United Kingdom and Spain ranking second and third respectively.

More favourable demand factors in comparison with developments elsewhere have surely played a role in shaping the buoyant price developments in Ireland. Growth in real disposable income since the mid-1990s has been stronger than in any other industrial country and real interest rates were among the lowest (Figure 7.2). The decline in inflation has also contributed by front-loading mortgage repayments. Furthermore, demographic trends were particularly favourable to housing demand in the 1990s, including strong

Figure 7.1. **House price growth remains high**



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

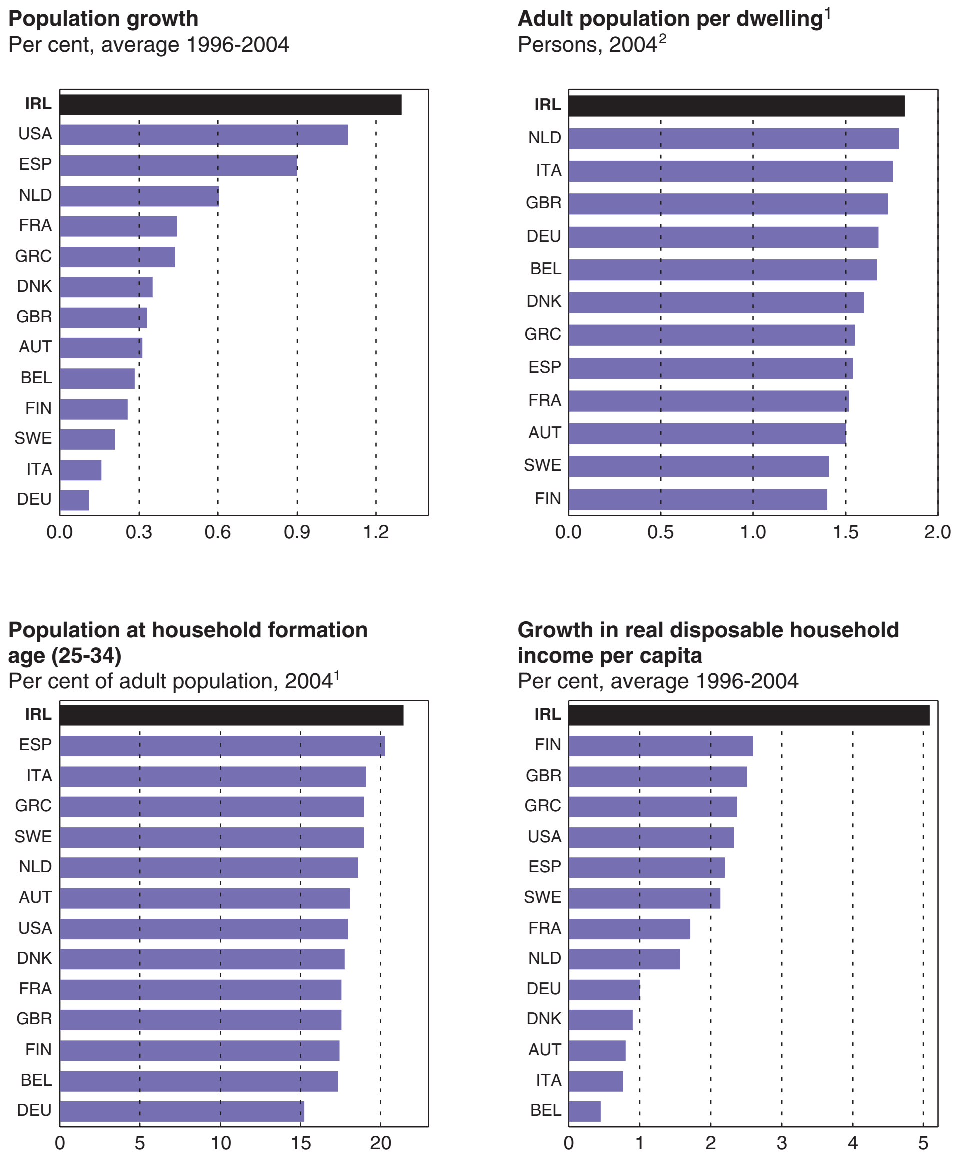
Source: Department of the Environment, Heritage and Local Government, *Quarterly Housing Statistics* and OECD, Main Economic Indicators database, February 2006.

population growth, a sharp fall in household size from a high level, a rapid acceleration in the growth of population in the household formation cohort and sizeable net immigration. Other demographic developments include the increase in the number of double income households and higher divorce rates. Another factor is the number of baby boomers investing in the buy-to-let market because of increasing worries about inadequate pension provisions for retirement.

In addition, the tax treatment of housing in Ireland has been more favourable for home ownership than in most other EU countries (van den Noord, 2005). This is reflected in a low user cost of capital. The user cost for homeowners is analogous to the cost of rental accommodation for tenants. It includes the after-tax mortgage interest rate net of capital gains, the opportunity cost associated with equity financing (usually the after-tax deposit rate), property tax (if any) and depreciation. There have been extended periods when the user cost has been negative, in particular in the late-1970s and from the mid-1990s onwards, implying a strong incentive to invest in housing.[1] The main driving factor keeping the user cost negative has been the untaxed capital gains (on owner-occupied homes), whereas the importance of income tax deductions has diminished with the gradual decline in marginal income tax rates and a series of other tax reforms (Box 7.1). Since taxation of capital gains has an important negative influence on the user cost, its absence could have acted as a catalyst for the upward spiral in house prices.

Access to mortgage finance is also less restrictive in Ireland than elsewhere, especially compared with continental Europe (Table 7.1). Financial market liberalisation during the 1980s and 1990s has supported demand by allowing a rapid expansion in credit. The full effects of liberalisation were beginning to be felt in the mid-1990s, just at the time when housing demand was growing fast. Loan-to-value ratios have risen from an average level of 60% in the 1980s to around 80% at present. The trend towards securitisation of bank loans is another factor. In general, securitisation makes interest rates on new borrowing more responsive to financial market developments. It also enhances competition, which lowers the costs of taking out a mortgage and makes it easier for households to access their

Figure 7.2. **Forces shaping house prices**



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

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

capital through housing equity withdrawals (Catte *et al.*, 2004). The adoption of the euro has been another important influence in helping to increase the elasticity of supply of mortgages. The exchange rate risk disappeared, removing one of the obstacles to the freer flow of funds within the euro area. This means that the domestically-based Irish banks have a hugely expanded pool of funds available. The removal of the exchange rate risk premium, by lowering interest rates, has also acted to stimulate demand for mortgages. Finally, most mortgages in Ireland are variable rate loans, so the reduction in short-term interest rates (until recently) has further boosted demand.

Box 7.1. **Tax breaks for housing and policy flip-flops**

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

- Ireland introduced a residential property tax in April 1983. The rate was 1½ per cent for properties above a certain value and where the owner's income exceeded a certain rate. The 1994 Budget adjusted these price and income thresholds, but those measures were scrapped in the following budget, with a return to the previous system. The property tax was abolished altogether two years later. A private residence of up to one acre is exempt from capital gains tax, which is large enough to cover virtually all houses.
- Mortgage interest can be deducted against income tax. Prior to 1974 there was no limit as the full cost of mortgage interest could be deducted at the marginal tax rate. A ceiling was introduced in 1974 and increased on two occasions, in 1993 and 2003. Both these increases followed prolonged periods in which interest repayments normally exceeded the ceiling. Mortgage interest relief was phased in at the standard rate of tax (as opposed to the marginal rate) in 1994. This saw a reduction in the benefit accruing to homeowners with the deductibility rate falling from 48% in 1993 to 26% in 1997. Meanwhile, the imputed rental income is not taxed, unlike rental income to a third party.
- A package of tax measures was introduced in 1998 in an attempt to deflate what appeared to be a housing bubble. Stamp duty on new houses that were not owner-occupied was increased, while stamp duty on second-hand houses was reduced; capital gains tax on disposals of qualified residential land was reduced; and tax breaks for rental income were removed. These were successful in stopping house price inflation – possibly too successful, as they were reversed in the 2002 Budget. Meanwhile, another package of measures was introduced in 2000 in order to discourage investors from buying rental property. This included a 9% stamp duty on the purchase of property for rent. That also worked but had the predictable side effect of driving up rents, so it was abolished just a year later. Stamp duty was changed again in the 2005 Budget, this time lowering the tax for first-time buyers.

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

The rise in housing demand triggered a strong response in supply, which again is unprecedented by international standards (Figure 7.3). House construction and residential permits per capita are among the highest in the OECD. Around a third of the housing stock is younger than ten years old. Half of the stock is detached houses, with apartments accounting for just 6%. The enormous increase in housing supply was accompanied by significant increases in real construction costs and land prices. The significant cost increases did not deter the supply of housing, which was aided by more relaxed zoning rules. Yet, despite the massive increase in the housing stock, it will almost certainly increase further in the medium term (even ignoring the effect of population growth) given

Table 7.1. **Mortgage and housing market indicators**

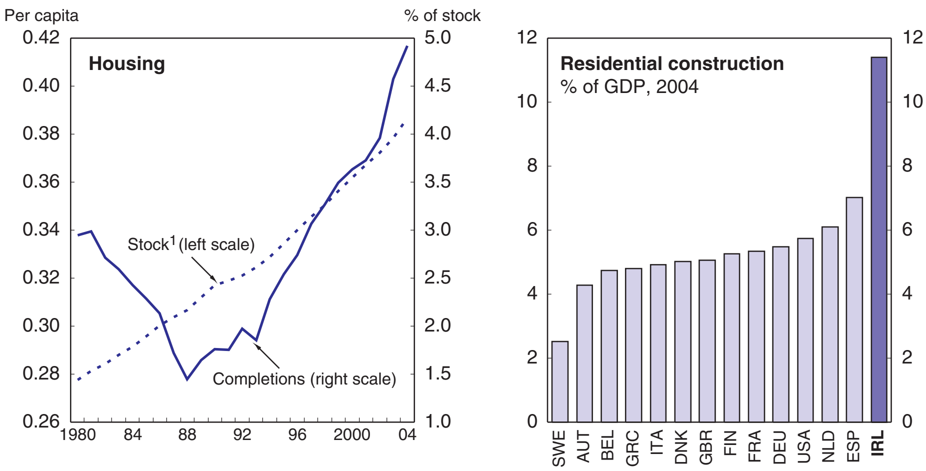
	Residential mortgage debt (% of disposable income, 2003)[1]	Typical loan-to-value ratios of new loans (%)	Typical loan term (years)	Variable interest rates (% of all loans, 2002)[2]	Securitisation of mortgages	Home ownership rate (%, 2002)[2]
Ireland	**106**	**70-100**	**20**	**85**	**Limited**	**77**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

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

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

that in Ireland there are significantly more adults per dwelling than in other OECD countries. If preferences in Ireland were similar to those in other EU countries, this would, *ceteris paribus*, lead to falling numbers of (adult) persons per dwelling. This gap has undoubtedly been a factor in the buoyant demand for housing and a driving force behind

Figure 7.3. **Residential construction is booming**



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

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

the escalation of house prices, and is likely to act for several more years. Indeed, the high cost of accommodation in Ireland may be discouraging people from forming an independent household (Fitz Gerald, 2005).

Are house prices overvalued?

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

Econometric evidence

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

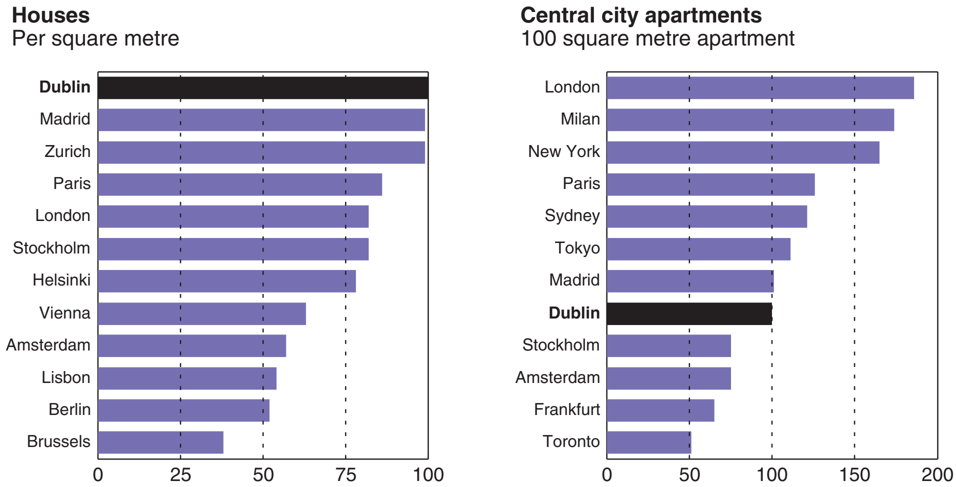
The available econometric evidence does suggest that prices have overshot their fundamental value. It is worth noting, however, that around 80 to 90% of the increase in house prices since 1995 is justified by the fundamentals – rising incomes, lower interest rates, demographic factors, etc. The remainder appears to be speculative froth. The model described in the annex to this chapter estimates that average house prices have been diverging from their fundamental level in recent years and were perhaps 10-20% overvalued in the middle of 2005 (although all econometric models obviously are subject to considerable uncertainty, due to modelling error, omitted variable bias and so forth). This estimate is broadly consistent with a similar analysis conducted by the IMF (2004). Some models presented in the central bank's *Financial Stability Report 2005* show an estimated over-valuation ranging from essentially zero to more than 70%, highlighting that it is necessary to look at more than one indicator (and to make judgements about which indicators may be more reliable than others).

International comparisons

It is difficult to compare prices across countries because the size, quality, location and amenities of houses can differ substantially. Comparisons are a little easier if they are restricted to the major cities, but this does not solve the problem entirely. Bearing this in mind, the available evidence suggests that average prices in Dublin are higher than in comparable cities. In a comparison of average sale prices in 2004 across a dozen European cities, the price per square metre was higher in Dublin that everywhere else (Figure 7.4, left panel). Some further evidence comes from cost-of-living comparisons conducted by various private-sector consultancies. These usually focus on prices or rents of inner-city apartments typically bought or rented by business executives. Here Dublin does not stand out so dramatically (Figure 7.4, right panel).[2] This may be because rents are not especially

Figure 7.4. **Average house prices**

Dublin = 100, 2004



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

high in Ireland but it may also reflect urban sprawl. Anecdotally at least, there is not a great deal of diversity in the housing stock. The centres of the main cities have not been taken over by apartment complexes and there is relatively little high-density in-fill housing. If preferences change and Irish people become more comfortable living in downtown apartments or in higher-density housing with no garden, then the distribution of prices may become more uneven: house prices in the central city may rise significantly relative to prices in the suburbs and city fringes. There is some evidence this may be happening already (Policy Exchange, 2005).

Owning versus renting and the "great ratios"

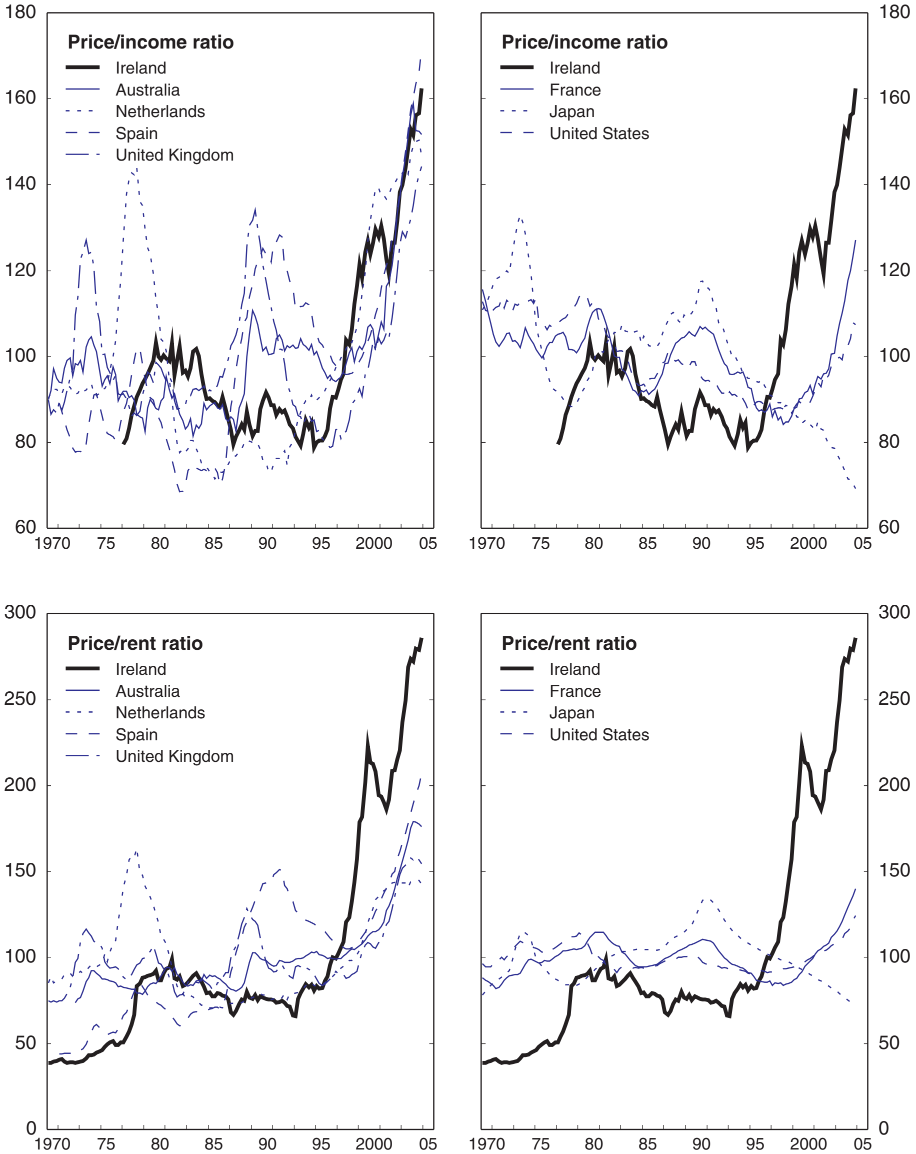
In a majority of countries, the ratios of prices to rents and prices to disposable income do not have strong trends when considered over long periods of time. The ratios may rise sharply during housing booms, but they usually fall back again through a combination of falling real house prices (*i.e.* a lower numerator) and rising rents or incomes (the denominator rising to catch up). In Ireland's case, the increase in these two ratios far outstrips the cycles that have been seen in other countries before the most recent global housing boom (Figure 7.5), although the increase in the price-to-income ratio is in line with some other countries that have also enjoyed booming house prices in the last five years.

The forward-looking present value approach

In theory, permanently lower interest rates should lead to permanently higher price-to-rent and price-to-income ratios. Therefore, *some* increase in these ratios, as identified in the previous paragraph, is justified by the decline in Irish real interest rates. Whether the run-up is *fully* justified can be assessed using the forward-looking present value approach. It determines the fundamental house price as the present discounted value of expected future rental income from the property and has the advantage over econometric models that it relates the fundamental price to expectations of the future rather than comparing it to past developments. Real incomes have now converged to the euro area average but

Figure 7.5. **House prices are generally high relative to rents and income**

Sample average = 100



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

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

Affordability

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

Other evidence

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

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

Demand for second homes appears to be another important factor in the housing market. Although housing supply has risen tremendously in recent years, a surprisingly large proportion of it appears to be satisfying demand for second-home properties (in 2005, around 15% of homeowners aged 35-54 owned a second home). As in the case of the buy-to-let market, some properties may have been acquired with the expectation that house prices would continue to grow at a fast pace for the indefinite future. More generally, an important element of the boom over the last decade has been the growth in the number of dwellings that are vacant, for whatever reasons, for most of the year. Fitz Gerald *et al.* (2003) calculated that the number of vacant dwellings in Ireland had increased by 80 000 from 2000 to 2003, which is equivalent to half the houses constructed over that period. On the basis of modelling work in that paper it was estimated that this additional demand would have added between 15 and 20% to house prices over the same period, which roughly corresponds to the estimated overvaluation reported in Annex 7.A1.

Key policy issues

Risks to financial stability

An over-valued housing market may have implications for financial stability, but that depends on many factors. The first point to note is that an overvaluation does not imply that prices will drop, at least if the degree of overvaluation is moderate. The housing market is unlike other asset markets in that house price dynamics are not symmetric. Prices rise quickly during booms, but in a market slump most people prefer to take their house off the market rather than sell at a loss. Hence, a *small* fall in prices followed by several years of a flat market is more likely than a sharp drop in house values. Put another way, the price level may remain fairly high as the market waits for the underlying fundamentals to catch up. Another factor working in favour of this benign scenario is that, in the past, house price slumps have usually been triggered by a hike in interest rates, and while interest rates in the euro area are back on an upward path, the increase is likely to be relatively mild – a hike in rates has usually been the trigger for price slumps in the past. But even if they are not overvalued, concerns about stability still arise. If the fundamental drivers were themselves subject to severe negative shocks – such as a slowdown in the expected growth rate of disposable income – then house prices could still fall substantially. This would be particularly difficult for households that are highly leveraged in the buy-to-let and secondary home markets. The sensitivity of these markets to changes in financial conditions may be illustrated by the hit to confidence and the subsequent halt in real house price growth in 2001-02 when the budget announced an increase in the stamp duty and the introduction of an anti-speculative property tax (Box 7.1). The potential magnitude of the problem is difficult to gauge. Average debt levels are high and are growing rapidly (Table 7.1), but there is little up-to-date information on how this is distributed across households. The current level of rents is not adequate to cover debt service costs for new or very recent investors (*i.e.* those with a loan-to-value ratio of at least 80%), so their financial position will be squeezed if prices do not rise as fast as they had hoped. Even if house prices level off, there is a potential macroeconomic and financial stability issue that could arise from decline in residential construction. As noted in Chapter 1, the rate of house building will need to fall to some extent to return to its sustainable long-run level. International experience shows that this process is seldom smooth: when the investment rate turns down, it usually falls sharply (Box 7.2).

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

Longer-term economic efficiency

Aside from the question of whether house prices are currently overvalued, there are also issues of longer-term welfare related to the housing market. The share of the average household budget that is spent on housing is very high by international standards – it is the second highest in the European Union after the United Kingdom.[5] This suggests there may

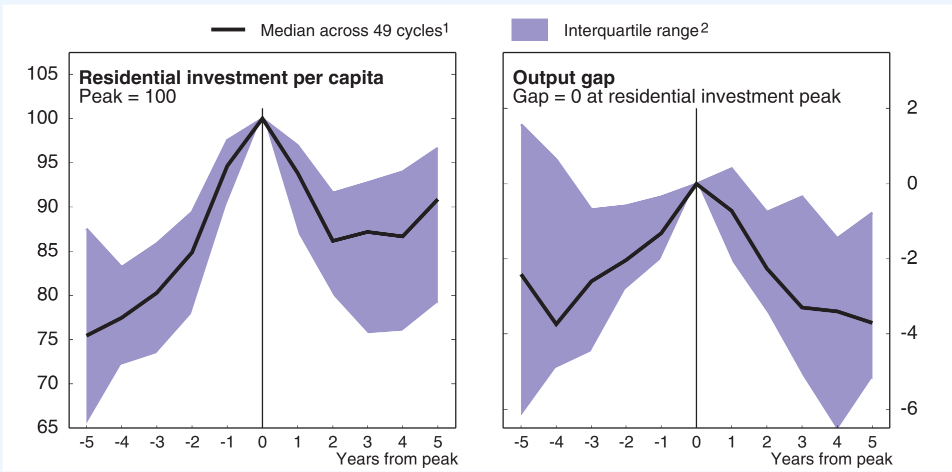
Box 7.2. **Has residential construction ever had a soft landing?**

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

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

The downturn that follows is usually rapid. On average in the first year after the peak, 40% of the increase during the trough-to-peak upswing is reversed, with another 40% lost in the second year (Figure 7.6). Investment stabilises at that level for two years, before beginning to recover about five years after the peak.

Figure 7.6. **Has there ever been a soft landing?**



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

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

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

Box 7.2. **Has residential construction ever had a soft landing?** *(cont.)*

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

be over-investment in housing and a corresponding under-investment in more productive assets.

The scarcity of accommodation in Ireland is partly a matter of misallocation of resources. To the extent that the increased stock of dwellings is absorbed as secondary or vacant dwellings, there are fewer dwellings available to meet the rise in the number of households driven by the changing age structure of the population. This has also put pressure on the resources of the building industry. Moreover, as noted by Fitz Gerald (2005) the high demand for secondary homes makes it more expensive for individuals to live and run businesses in the regions. The provision of the necessary infrastructure for new dwellings, such as sewerage and water connections, is very expensive, especially in urban areas. Where such dwellings are held vacant for investment purposes,[6] there is not an occupier to generate tax revenues to help defray the costs. Moreover, the government's social housing policy may be putting undue pressure on property prices (Box 7.3).

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

Tax policy issues

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

Box 7.3. **Housing support may not be provided in the most cost-effective way**

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

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

Box 7.4. **Summary of recommendations**

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

Notes

1. For Ireland, the user cost is computed by Barham (2004) following the method of Poterba (1984).
2. The figures in the right-hand panel come from the Economist Intelligence Unit and are based on a 100 m^2 apartment close to the city centre. They are highly correlated with the Union Bank of Switzerland's cost of living comparison in different cities (correlation coefficient of 0.78).
3. In 2004, around 8% of the housing stock was for private rental.
4. Loan loss provisions fell from 1.4% of loans in 2000 to 0.7% in the second quarter of 2005 (Central Bank, 2005). This level is in line with other European countries (Hoeller *et al.*, 2004).
5. The simple way to see this is to compare the level of house prices in Ireland relative to other countries. More rigorous statistical comparisons of the cost of living across countries compiled by Eurostat generate the same conclusion (see Eurostat data table COLC_NAT under subject Prices, Intra-EU correction coefficients).
6. There was a strange tax loophole until 2002 which meant that it could be worthwhile for a landlord who owned multiple properties to buy an additional property and keep it vacant.

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THEME: C1

Effectiveness of the ECOFIN and Domestic Standing Group (DSG) (Central Bank, Financial Regulator and Department of Finance)

LINE OF INQUIRY: C1d

Adequacy of the DSG process, including a consideration of the bank resolution legislation

Draft of

BILL

entitled

Credit Institutions (Financial Support) Bill 2008

Credit Institutions (Financial Support) Bill 2008

ARRANGEMENT OF SECTIONS

Acts referred to

Central Bank Act 1997	1997, No. 8
Central Bank and Financial Services Authority of Ireland Act 2003	2003, No. 12
Companies Act 1963	1963, No. 33
Companies Acts	
Competition Act 2002	2002, No. 14
Finance Act 1970	1970, No. 14
National Treasury Management Agency Act 1990	1990, No. 18

Credit Institutions (Financial Support) Bill 2008

BILL

entitled

An Act to provide, in the public interest, for maintaining the stability of the financial system in the State and for that purpose to provide for financial support by the Minister for Finance in respect of certain credit institutions, to amend the Competition Act 2002 and other enactments, and to provide for connected matters.

BE IT ENACTED BY THE OIREACHTAS AS FOLLOWS:

33

Lonergan, Ciara

From: Lonergan, Ciara
Sent: 24 April 2008 17:43
To: Manley, Michael; Nolan, Kevin
Subject: State Guarantee Act 1954

Michael/Kevin

You asked me to examine the potential for amending the State Guarantee Act 1954 to allow the Minister to provide a guarantee to an financial institution or the CBFSAI should it be required.

The SGA 54 provides for the Minister to guarantee the borrowings of specified bodies. The bodies that the Minister can provide a guarantee to are listed in a Schedule to the Act. Section 9 gives the Minister the power to amend by order this Schedule by changing the maximum amount of the guarantee specified in the Schedule, by deleting a body from the Schedule, or by adding a body and its maximum guarantee to the Schedule.

[redacted]

There are a number of issues that arise if we wish to amend the SGA 54:

- The purpose of the SGA 54 is to provide for "guarantee by the Minister for Finance in respect of moneys borrowed by certain bodies". It specifies the maximum amount of any guarantee to specific bodies and **it does not provide the circumstances under which the Minister would undertake such a guarantee.** If we want to use this structure for a guarantee of a financial institution, following the McCreevy judgement, the principles and polices under which an Order that added this institution to the Schedule (thus making it eligible for a guarantee) was made would need to be stated in the Act. However, the principles and polices required for the type of guarantee the Minister might undertake to provide in order to manage financial stability would not necessarily be appropriate for other guarantees provided for in the Act as it currently stands.

- In additions the Act provides for the guarantee of borrowings, while the Minister might wish to guarantee the deposits of an institution in addition to its borrowings.

- The requirement to set out the maximum amount that be guaranteed could possibly restrict the types of guarantees that would be provided by requiring that a limit be set out in advance of the guarantee being entered into.

Given these concerns it may be easier and clearer to simply draft legislation to provide for the Minister to give guarantees which relate to financial stability management, outlining the possible circumstances in which such a guarantee could be considered, the criteria (non-exhaustive) that would apply to such a decision by the Minister, and the purpose that such a guarantee would be expected to fulfil. This could be inserted into existing legislation such as the Central Bank Act 1942, or it could be a stand alone piece of legislation.

Ciara