

## 3 Banking and Insurance Measures

- 3.1 During 2011, the State continued to implement measures to stabilise the banking system in Ireland through recapitalisation of domestic banks, provision of guarantees of deposits and certain other liabilities and through the provision by the Central Bank of Ireland of liquidity to financial institutions domiciled in Ireland. The main objectives of the banking stabilisation measures are to return banks to sustainable levels of profitability and to ensure that normal access to credit is restored for business, especially small and medium enterprises. In the longer term, the aim is for the State to dispose of its share holding in commercial banks.
- 3.2 Following the recapitalisation of the banks, the sale of a €1 billion stake in Bank of Ireland to private investors and the purchase of Irish Life by the State, the State's total investment in Irish financial institutions by end July 2012 was €65.2 billion. The State owns 15% of Bank of Ireland and all, or almost all, of Allied Irish Banks plc (AIB), Permanent TSB Group Holdings plc (Permanent TSB – formerly Irish Life and Permanent) and Irish Bank Resolution Corporation (IBRC).<sup>1</sup>
- 3.3 The Insurance Compensation Fund which operates under the control of the President of the High Court, was set up to meet liabilities of insolvent insurers. While the Fund is ultimately funded by levies on policy holders, the Minister for Finance may make advances from the Exchequer in circumstances where the Fund is unable to meet a payment approved by the High Court in a timely way. In 2011, the joint administrators of Quinn Insurance Ltd (QIL) applied to the High Court for funding to be provided from the Fund due to the assets of QIL being insufficient to meet estimated liabilities.
- 3.4 The purpose of this chapter is to
- provide an update of the cost to the State of the banking stabilisation and insurance resolution measures taken
  - set out the revised arrangements for managing the State's investments in the banks
  - outline the credit availability measures taken to date.

### Implementation of Banking Stabilisation Measures

- 3.5 Measures taken in 2011 to address the financial stability of credit institutions in Ireland included
- restructuring of the banking system
  - purchase of impaired bank assets
  - capitalisation of certain credit institutions
  - guarantees of certain liabilities of credit institutions
  - provision of liquidity support and
  - deleveraging in order to restore the banks to a more stable funding position.

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1 Formerly Anglo Irish Bank (Anglo) and Irish Nationwide Building Society (INBS).

### ***Restructuring the Banking System***

- 3.6** In early 2011, the Minister for Finance (the Minister) announced the Government's restructuring plan for the banks, whereby the Irish banking system would have two full-service banks (AIB and Bank of Ireland) as its core pillars, as well as a restructured Irish Life and Permanent. Key elements of the restructuring were
- Pursuant to orders of the High Court, €8.6 billion of deposits were transferred in February 2011 from Anglo to AIB and €3.6 billion from INBS to Irish Life and Permanent, along with assets to support the liabilities.
  - The High Court granted a transfer order on 1 July 2011 to the effect that the remaining assets and liabilities of INBS transferred with immediate effect to Anglo.<sup>2</sup>
  - AIB completed the acquisition of the Educational Building Society (EBS) for a nominal payment of €1 on 1 July 2011.<sup>3</sup>
  - On 14 October 2011, Anglo officially became known as IBRC, which is now in wind-down mode. During 2011, the net loan assets held by IBRC fell by €8.1 billion to €18.7 billion.<sup>4</sup>

### ***Purchase of Impaired Bank Assets***

- 3.7** The National Asset Management Agency (NAMA) was established to acquire loans that had been advanced for the purchase and development of land and other related advances from five credit institutions that participated in NAMA<sup>5</sup>.
- 3.8** By the end of 2011, NAMA had paid €31.8 billion to banks to purchase loans in respect of which the borrowers owed just over €74 billion. The loss incurred by the credit institutions on the loans was of the order of €42.4 billion, or 57% of the loans' carrying value. NAMA's financial statements for 2011 reported a total impairment provision of €2.75 billion on the loans it had acquired.
- 3.9** NAMA issued debt to pay for the loans. 95% of the debt was in the form of floating rate notes guaranteed by the Minister.

### ***Capitalisation of Credit Institutions***

- 3.10** By the end of 2010, the State had made capital injections of €47 billion into financial institutions.<sup>6</sup> In March 2011, the Central Bank published a financial measures programme (FMP) report setting out the results of a prudential capital assessment review (PCAR 2011). This identified the further capital requirements of three institutions at €24 billion.<sup>7</sup>
- 3.11** By mid-2012, the State had invested a further €18.2 billion (including investment of dividend receipts in ordinary shares in AIB and Bank of Ireland)<sup>8</sup>, bringing the total investment to €65.2 billion, comprising

<sup>2</sup> The order was made under section 34 of the Credit Institutions (Stabilisation) Act 2010

<sup>3</sup> The Minister approved the acquisition under section 7(11) of the Credit Institutions (Financial Support) Act 2008.

<sup>4</sup> Annual Report 2011, IBRC.

<sup>5</sup> The five credit institutions were Anglo, AIB, Bank of Ireland, INBS and EBS.

<sup>6</sup> AIB (incorporating EBS), Bank of Ireland, Irish Life and Permanent and IBRC.

<sup>7</sup> AIB, Bank of Ireland and Irish Life and Permanent. Irish Bank Resolution Corporation was not subject to PCAR 2011.

<sup>8</sup> The Department is of the view that the dividends paid in the form of ordinary shares (€1.1 billion in total to end July 2012) should be excluded from the total investment (and from the return on investment) on the basis that they were not cash outlays.

- €44.45 billion in investment from the Exchequer issued by the Minister, (€13.6 billion in cash and €30.85 billion by way of promissory notes) and
  - €20.75 billion invested by the National Pensions Reserve Fund (NPRF).<sup>9</sup>
- 3.12** On 24 July 2011, the Minister directed the NPRF to sell part of its shareholding in Bank of Ireland. The net proceeds of the sale, which amounted to €1,018 million after costs of €34 million were deducted, were remitted to the Exchequer on the direction of the Minister.
- 3.13** Following the recapitalisations and sale of shares in Bank of Ireland, the State owned
- 15% of the ordinary share capital of Bank of Ireland
  - 99.8% of the ordinary share capital of AIB
  - 100% of IBRC
  - 99.2% of Irish Life and Permanent.<sup>10</sup>
- 3.14** Figure 3.1 provides details of the capital injections made up to the end of July 2012.

**Figure 3.1 Capitalisation of Credit Institutions July 2012**

Credit Institution	IBRC	AIB	Bank of Ireland	Irish Life and Permanent	Total
	€ bn	€ bn	€ bn	€ bn	€ bn
Cost of ordinary share acquisition <sup>a</sup>	4.1	10.2	2.1	2.3	18.7
Cost of preference shares <sup>b</sup>	—	3.5	1.8	—	5.3
Contingent capital notes <sup>c</sup>	—	1.6	1.0	0.4	3.0
Capital contribution <sup>d</sup>	—	6.1	—	—	6.1
Value of promissory notes issued	30.6	0.2	—	—	30.8
Purchase of Irish Life	—	—	—	1.3	1.3
<b>Total</b>	<b>34.7</b>	<b>21.6</b>	<b>4.9</b>	<b>4.0</b>	<b>65.2</b>

Source: Department of Finance

- Notes:
- a Ordinary shares acquired are shown net of fees and include dividends on preference shares received in the form of ordinary shares (AIB - €849 million and Bank of Ireland - €250 million). The shareholding in Bank of Ireland is net of €1 billion received by the NPRF for the sale of shares in the bank in July 2011.
  - b In March 2009, the NPRF invested €3,500 million in preference shares in Bank of Ireland. In April 2010, €1,663 million of these shares were converted to ordinary shares (included in ordinary shares above).
  - c Contingent capital notes qualify as core tier two capital. They convert to ordinary shares under certain circumstances, including if the core tier one capital ratio falls below 8.25%.
  - d The capital contribution was made by the Minister for Finance (€2.28 billion) and the NPRF (€3.77 billion).

<sup>9</sup> Pursuant to directions issued by the Minister, the NPRF had, at July 2012 invested a net €20.75 billion in AIB and Bank of Ireland following the receipt of €1 billion arising from the sale of shares in Bank of Ireland. The overall investment is net of fees and includes investment of €1.1 billion from receipts of dividends on preference shares. The NPRF Commission cannot take any actions in regard to those investments other than in accordance with the Minister's directions. Chapter 4 provides further details on investments by the NPRF.

<sup>10</sup> Two legal challenges have been taken in relation to the injection by the State of capital in Irish Life and Permanent.

- 3.15** The State currently intends to sell Irish Life. The amount to be realised on disposal will depend primarily on the financial performance of the company and market conditions at the time of the sale.
- 3.16** By the end of June 2012, the NPRF had received a return of just over €0.9 billion in cash from its investments, excluding fees offset against the cost of the investments, and a further €1.1 billion in dividends on preference shares received in the form of ordinary shares. In July 2012, the Exchequer received €0.3 billion in interest on the contingent capital notes.
- 3.17** The adequacy of the capital injected into the banks and their net asset value following their restructuring will be determined by the extent of the losses they incur. The projected losses as set out in the FMP report were that
- €20 billion to €27.7 billion of (gross) losses would be incurred in the normal course of their business.<sup>11</sup>
  - A further €13.2 billion of (gross) losses would be incurred from deleveraging through the disposal of certain assets in order to achieve liquidity ratio targets.<sup>12</sup>
  - The three banks would incur net losses of between €19 billion and €27 billion between 2011 and 2013, in addition to €10 billion that had been provided for by the banks in the form of loan impairment provisions at the end of 2010. These net projected losses take account of €3.9 billion in operating profits in a stress case scenario.
- 3.18** Overall, the assumptions in the FMP report are consistent with the assisted banks holding core tier one capital of the order of €13.7 billion to €21.4 billion by 2013. This asset value would accrue to the shareholders. The amount attributable to the State investment will be proportional to its shareholding. The residual value of the capital injections that the State has made into IBRC will be dependent on the financial performance of the bank and the amounts realised from the disposal of the assets in the merged entity.
- 3.19** In the memorandum of understanding following the fifth review of the EU/IMF programme, there is a commitment that the Central Bank will carry out, by the end of November 2012, a review of how the banks have performed relative to PCAR 2011.<sup>13</sup> The details of the review will be agreed between the Irish authorities and the staff of the European Commission, the ECB and the IMF. The results of the review will be published.

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11 Projected losses are €20 billion under a baseline scenario and €27 billion under a stress scenario.

12 Set out in a prudential liquidity assessment review (PLAR 2011).

13 In 2011, the three banks reported aggregate losses of around €2.5 billion while in the first six months of 2012 the two largest institutions reported further aggregate losses of €2.4 billion. However, the Central Bank states that the resulting financial performance of the banks in the period since the announcement of PCAR 2011 cannot be viewed as a measure of how the banks are performing relative to the financial performance assumed in PCAR 2011 due to changes in, inter alia, impaired loans and provision recognition requirements.

### ***Liabilities under Guarantee Schemes***

**3.20** Certain liabilities of banks have been guaranteed by the State under three main schemes.

#### *Deposit Guarantee Scheme*

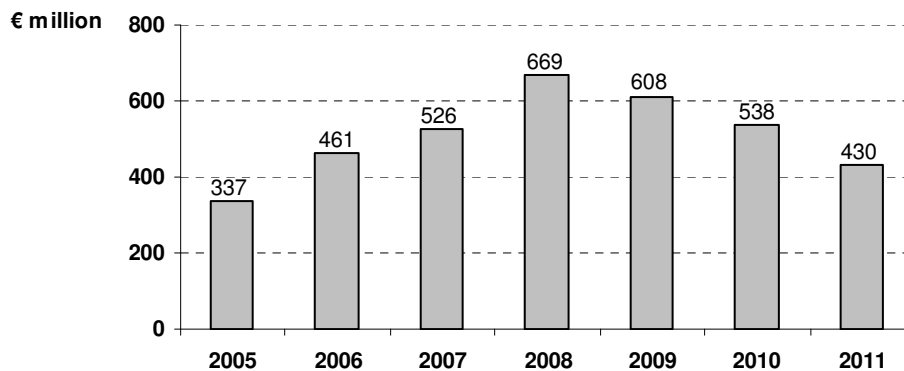
**3.21** Under the Deposit Guarantee Scheme, deposits by individuals in credit institutions that are licensed to receive deposits in Ireland and are authorised by the Central Bank are guaranteed up to a limit of €100,000 per eligible depositor per institution.<sup>14</sup>

**3.22** Credit institutions subject to the provisions of the scheme are required to deposit funds, to the value of 0.2% of all current customer deposits held by the institution, in a Deposit Protection Account administered by the Central Bank. Any claims of depositors under the scheme would be met in the first instance from the resources of the Deposit Protection Account and any residual shortfall would then be met from the Central Fund of the Exchequer, which would be recouped in due course from the banking sector. No claims have been made under the scheme since its inception.

**3.23** The extension of the scheme in 2009 included a provision that credit union deposits would be covered and legislation provided for this. An order has not yet been made requiring credit unions to hold funds in the Deposit Protection Account.

**3.24** At the end of 2011, 41 credit institutions were subject to the provisions of the scheme. The balance in the Deposit Protection Account was €430 million. The reduction in the balance since 2008 reflects reduced levels of deposits in Irish banks, year on year (see Figure 3.2).

**Figure 3.2 Deposit Protection Account Balance at year end 2005 to 2011**



Source: Central Bank Statement of Accounts 2005 to 2011

#### *CIFS Bank Guarantee Scheme*

**3.25** The Credit Institutions (Financial Support) Scheme (the CIFS Bank Guarantee Scheme), which operated from September 2008 to September 2010, provided a guarantee for a broad range of bank liabilities for seven covered institutions that opted to avail of the scheme.<sup>15</sup>

<sup>14</sup> Financial Services (Deposit Guarantee Scheme) Act 2009.

<sup>15</sup> The legal basis for the scheme was provided through the Credit Institutions (Financial Support) Act 2008, which was signed into law on 2 October 2008. The institutions that availed of the scheme were AIB, Anglo, Bank of Ireland, EBS, Irish Life and Permanent, INBS and Postbank Ireland Limited (the 'covered' banks).

**3.26** The CIFS Bank Guarantee Scheme expired on 29 September 2010 and any liabilities that had not transferred to the Eligible Liabilities Guarantee Scheme by that date no longer benefited from a Government guarantee.

**3.27** The covered institutions were required to make payments for the protection provided under the scheme. As a result, just over €759 million was received from the credit institutions and almost €5 million in interest was earned on the balances held. After the expiry of the scheme, the total amount raised was paid over to the Exchequer as no claims had been made.

#### *Eligible Liabilities Guarantee Scheme*

**3.28** The Eligible Liabilities Guarantee Scheme (ELG scheme) was designed to provide a longer-term guarantee of certain banking liabilities and came into effect on 9 December 2009. The scheme is administered by the National Treasury Management Agency (the NTMA) on behalf of the Minister.

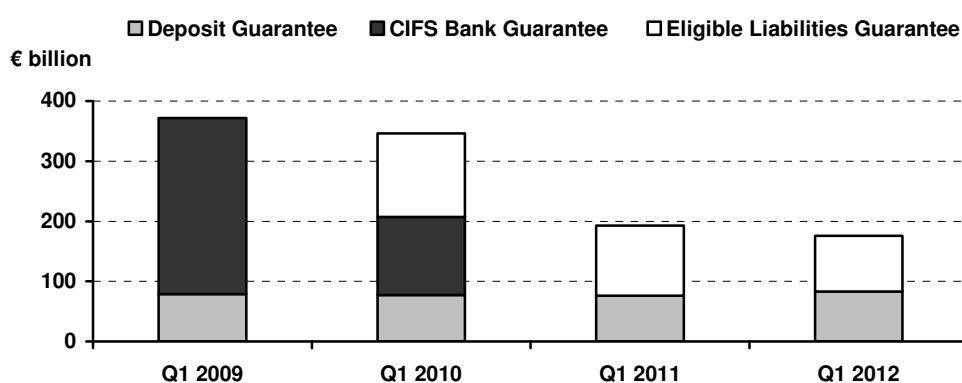
**3.29** The scheme requires approval every six months from the European Commission under EU State aid rules and was most recently approved in June 2012. This approval means that eligible debt securities and deposits issued or rolled over on or before 31 December 2012 may be guaranteed under the scheme, up to a maximum maturity of five years.

**3.30** The four institutions participating in the ELG scheme pay a fee for the cover they receive.<sup>16</sup> The payment level for liabilities depends on factors such as the maturity profile and amount of the liabilities, and is based on ECB recommendations on pricing government guarantees of banking liabilities. Fee payments are made into a designated account at the Central Bank and are paid quarterly to the Exchequer in arrears. Fees collected to the end of June 2012 amounted to €2.61 billion of which €2.36 billion had been paid to the Exchequer.<sup>17</sup>

#### *Aggregate Value of Covered Liabilities*

**3.31** Figure 3.3 indicates the estimated total value of the liabilities covered by the guarantee schemes at the end of each quarter from December 2008 to June 2012.

**Figure 3.3 Guaranteed Liabilities of Covered Institutions, December 2008 to June 2012<sup>a</sup>**



Source: Department of Finance

Note: a The guaranteed deposits included here relate only to eligible deposits in the institutions that were covered by the liability guarantee schemes.

<sup>16</sup> AIB, IBRC, Bank of Ireland and Irish Life and Permanent.

<sup>17</sup> €251 million in fees paid by the institutions in the period April to June 2012 had yet to be paid to the Exchequer.

### ***Liquidity Support for Banks***

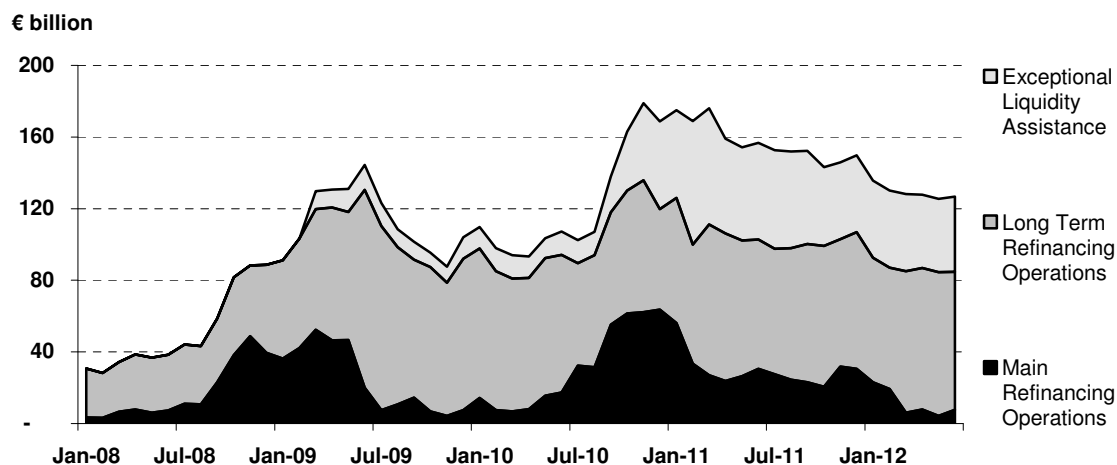
- 3.32** The Central Bank, through Eurosystem monetary policy operations, provides liquidity to the banking sector in the form of advances to credit institutions based in Ireland. Both retail and international banks can avail of Eurosystem liquidity through the Central Bank. Advances under the Eurosystem fall into two broad categories
- The Main Refinancing Operations (MRO) generally comprise weekly offers of loans with a maturity of one week.
  - The Long Term Refinancing Operations (LTRO) comprise mainly monthly offers of loans with a maturity of three months. In August and October 2011, the ECB introduced supplementary LTROs with a maturity of six months and twelve months respectively. In December 2011 and March 2012, two LTROs with a maturity of 36 months were introduced. These LTROs allow counterparties the option of early repayment after 12 months.
- 3.33** All the advances are secured by collateral approved by the Eurosystem. The credit institutions whose loans were acquired by NAMA can use the floating rate notes they received as consideration for the loans to obtain collateralised liquidity from the Eurosystem under monetary policy operations because the notes qualify as eligible collateral.
- 3.34** In addition to liquidity provision within the Eurosystem monetary policy operations, the Central Bank is also permitted, where required, to provide a certain level of exceptional liquidity assistance (ELA) to domestic credit institutions.<sup>18</sup> As with the Eurosystem monetary policy operations, the ELA lending must be collateralised. In addition to loans (including residential mortgages and investment or development loans), promissory notes issued by the Minister and guarantees of the Minister are eligible collateral for banks availing of ELA from the Central Bank.<sup>19</sup> In addition, the Central Bank has received letters of comfort from the Minister. These confirm that any shortfall on the liquidation of collateral can be made good by the State.
- 3.35** Total lending under Eurosystem monetary policy operations and ELA increased significantly from €31 billion at the end of January 2008 to a peak of just under €180 billion in early 2011 (see Figure 3.4). From the second quarter in 2011, the level of liquidity support fell steadily to around €150 billion by the end of 2011. The drop in demand for liquidity during the second quarter of 2011 coincided with the placement of around €19 billion of State funds on deposit with Irish commercial banks (€10 billion by the NPRF and €9 billion from Exchequer funds) prior to the funds being used for recapitalisation of the banks. During the first half of 2012, the demand for liquidity fell by a further €23 billion, with outstanding lending at €127 billion by the end of June. The covered institutions accounted for €106.5 billion, or 84% of this total.

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<sup>18</sup> The Central Bank statistics do not disclose the amount of ELA provided. Up to end of March 2012 ELA was represented in 'Other assets'. It is now categorised under 'Other liabilities to euro area credit institutions in euro'. At end 2010 and end 2011, ELA made up over 98% of this category.

<sup>19</sup> Where appropriate, discounts have been applied to the collateral by the Central Bank.

**Figure 3.4 Eurosystem and Central Bank of Ireland Lending to Credit Institutions, January 2008 to June 2012**



Source: Central Bank of Ireland Monthly Money and Banking Statistics

Note: Exceptional Liquidity Assistance includes a small element of other assets.

### ***Deleveraging***

- 3.36** Under PLAR 2011, AIB, Bank of Ireland and Irish Life and Permanent are required to achieve loan-to-deposit ratios (LDRs) of 122.5% by December 2013.<sup>20</sup> The aim of this requirement is to return the banks to a more appropriately leveraged and more stable funding position and also to reduce the banks' reliance on short term funding from the Central Bank.
- 3.37** The banks are required to report quarterly to the Central Bank which then monitors their progress in achieving six-monthly interim LDR targets. Each bank has a deleveraging committee to govern, monitor and oversee its deleveraging plans. Representatives of the Department of Finance (the Department) and the Central Bank attend the meetings of those committees, as non-voting observers. The Department has established a deleveraging review committee to oversee and monitor the operation of the institutions' deleveraging committees and to refer transactions that give rise to actual or potential financial stability considerations to the Central Bank for joint consideration.

### ***Level of Deposits***

- 3.38** In order to achieve the target LDR of 122.5%, financial institutions can either increase deposits or reduce their net customer loan balances. In making their plans to achieve the targets, the banks were instructed to assume a maximum of zero deposit growth between end 2010 (when deposits totalled €142.1 billion) and end 2013 with some exceptions, resulting in an end 2013 deposit level of €151.5 billion. As a result, the primary driver in the improvement in the LDRs was expected to be deleveraging – the reduction of loans through disposal and run down of non-core portfolios.
- 3.39** The Department has stated that in practice, deposit levels in the three banks grew by some €10 billion by end May 2012 – significantly faster than envisaged in the PLAR 2011 review.

<sup>20</sup> PLAR 2011 referred to four institutions. The incorporation of the EBS into AIB reduced the number to three.

### *Reduction in Net Customer Loan Balances*

- 3.40** Each of the banks was required to separate its assets into core and non-core portfolios. The core assets are primarily those elements of the business that support the domestic economy.<sup>21</sup> In the PLAR 2011, the amount of assets designated for deleveraging across the three banks was set at €72.6 billion. This was subsequently revised to €70 billion (€11 billion from core loans and €59 billion from non-core loans). New lending is allowed for in the deleveraging plans in core areas such as small and medium enterprises (SMEs) and mortgages.<sup>22</sup>
- 3.41** In April 2012, the Department reported the banks' progress in meeting interim LDR targets as follows
- Bank of Ireland had met its Central Bank mandated interim ratio target at the end of 2011 when its LDR was 144%, down from 175% at end 2010. The LDR had further improved to 136% by June 2012 driven mainly by further loan balance reductions.
  - AIB had also met its mandated interim ratio target at end 2011 with an LDR of 138%, down from 165% at December 2010. By June 2012, the LDR had further improved to 125%.
- 3.42** The LDR based on Irish Life and Permanent's financial statements was 227% at end 2011, down from 249% at December 2010. This did not meet the target set by the Central Bank. The Department noted that the high LDR reflects the decision to postpone the sale of a subsidiary of Irish Life and Permanent, Capital Home Loans Ltd. as a result of a change in management's strategy for the bank which is being considered as part of the submitted revised restructuring plan; the subsidiary accounts for about 70% of Irish Life and Permanent's initial envisaged deleveraging requirement.
- 3.43** In a progress review report, the Department reported that at the end of December 2011 deleveraging of €36.4 billion had been achieved. This was more than half of the target. The Department noted that loan loss provisions for both AIB and Irish Life and Permanent were higher than those included in their respective deleveraging plans. It pointed out that the Central Bank allowed a certain amount of provisions to comprise part of the net loan balance reduction to be achieved over three years, and that this is lower than the total projected provision figure built into the March 2011 PCAR/PLAR exercise.<sup>23</sup>

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21 The FMP developed by the Central Bank states that the key principle governing the definition of core portfolios was the need to service the retail, Small and Medium Enterprises (SME) and corporate banking requirements of the Irish economy, including cross-border trade and investment, acknowledging that some limited element of international business remains essential. The split of assets and business between core and non-core was carried out by the banks using guidelines set out by the Central Bank.

22 A small enterprise has fewer than 50 employees and has either an annual turnover and/or an annual balance sheet total not exceeding €10 million. A medium enterprise has between 50 and 249 employees and has either an annual turnover not exceeding €50 million or a balance sheet total not exceeding €43 million.

23 Department of Finance, *Banking Division-Recent Progress and Deleveraging*, April 2012.

- 3.44** In an IMF report following the fifth quarterly review under the EU/IMF Programme of Financial Support for Ireland, the IMF pointed out the need to refine the deleveraging framework to minimise risks to domestic lending and deposit rates. The report noted that
- The faster than targeted deleveraging in 2011 was associated with larger run-offs of banks' core loan portfolios, potentially constraining domestic credit.<sup>24</sup>
  - The Irish authorities were concerned that targets for banks' LDRs had contributed to increased deposit interest rates and undermined bank income. The Irish authorities were considering adjusting the deleveraging framework to have separate targets for the net stable funding ratio for banks' core balance sheets and the nominal reduction in non-core assets.<sup>25</sup>
  - In view of deteriorating market conditions for bank assets given the large scale deleveraging efforts of other European banks, it was more likely that a safeguard against 'fire sales' already included in the deleveraging framework might need to be used in the first half of 2012, while a refined deleveraging framework was under development.
- 3.45** In response to the quarter two 2012 review of the EU/IMF programme, the Department stated that
- Fire sales and excessive deleveraging of core portfolios will be avoided so as not to impair the flow of credit to the economy.
  - The LDR target will be replaced with a net stable funding requirement benchmark. This will help alleviate some of the pricing pressures on the deposit market and allow the banks to adopt a broader perspective of their funding base.
- 3.46** An August 2012 Memorandum of Understanding<sup>26</sup> between the Government and the EU/IMF stated that the Irish authorities, in consultation with the staff of the European Commission, the IMF, and the ECB
- will assess banks' deleveraging based on the existing nominal targets for disposal and run-off of non-core assets in line with the 2011 Financial Measures Programme
  - will establish an advanced monitoring framework in relation to funding and liquidity monitoring, covering in detail all factors affecting banks' net stable funding ratio.
- 3.47** The Department noted that Bank of Ireland had announced that it had completed its divestment programme and that AIB stated in its interim results presentation that it expects its LDR to be at or below the target of 122.5% by December 2012, a year ahead of target.

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24 'Run-off' refers to circumstances where repayments by customers exceed new lending by banks.

25 The 'net stable funding ratio' for banks calculates the proportion of long term loans that are funded by long term stable funding.

26 Memorandum of Understanding on Specific Economic Policy Conditionality (6<sup>th</sup> update).

## Credit Availability

- 3.48** In return for the initial State recapitalisation, AIB and Bank of Ireland were required to undertake a number of initiatives providing credit for SMEs and entrepreneurs. This included a requirement for both banks to make available at least €3 billion each in new SME lending in 2010 and 2011 (a total of €12 billion). The requirement was increased to €3.5 billion for each bank for 2012 and to €4 billion for 2013.

### *Code of Conduct*

- 3.49** In January 2012, the Central Bank published an updated ***Code of Conduct for Business Lending to Small and Medium Enterprises*** ('code of conduct').<sup>27</sup> The code sets out the processes regulated entities are required to adopt in facilitating access to credit for SMEs. Its objectives are to
- facilitate access to credit for sustainable and productive business propositions
  - promote fairness and transparency in the treatment of SMEs by regulated entities and
  - ensure that when dealing with financial difficulty cases, the aim of a regulated entity will be to assist borrowers to meet their obligations, or otherwise deal with the situation in an orderly and appropriate manner.
- 3.50** The code of conduct applies to regulated entities when providing lending to SMEs operating within the State, with some limited exceptions. Regulated entities are required to comply with the code and must demonstrate this compliance.

### *Credit Review Office*

- 3.51** The Credit Review Office (CRO) was established as an independent body in March 2010.<sup>28</sup> Its primary function is to help ensure that credit is not refused to viable businesses with valid business propositions. It has no regulatory or statutory powers to override banks' lending decisions but gives an independent opinion on banks' credit decisions. Banks are required to comply with the CRO recommendations or explain why it would not be appropriate to do so.<sup>29</sup>

### *Review of Banks' Lending Targets*

- 3.52** The CRO publishes quarterly reports which include a general summary on each bank's lending outcomes. The seventh quarterly report, covering the period to the end of 2011, noted that both AIB and Bank of Ireland had met the target of sanctioning €3 billion in lending in 2011.
- 3.53** The eighth quarterly report set out the progress in the first quarter of 2012 against the new €3.5 billion lending targets for each bank and noted that the combined loan sanctions levels in quarter one were broadly similar to the first quarter of 2011. However, the report noted that lending transactions recorded by the two banks in the first quarter of 2012 were around 15% lower than the same quarter in 2011. Reasons given included

<sup>27</sup> The Code is issued under Section 117 of the Central Bank Act 1989 and applies to all business lending by regulated entities.

<sup>28</sup> Statutory Instrument 127 of 2010 – Guidelines issued under Section 210(1) of the National Asset Management Agency Act 2009 regarding lending practices and procedures and relating to the review of decisions of Participating Institutions to refuse credit facilities

<sup>29</sup> The banks to which the operations of the CRO currently apply are AIB (including EBS), Bank of Ireland and IBRC.

- reduced demand for borrowing by SMEs reported by the banks and observed in both a review of lending demand commissioned by the Department and recent Central Bank reporting
- borrowers paying down debt rather than seeking new loans
- tighter credit conditions being applied by banks.

**3.54** The CRO report stated it had noted that banks' processing of SME credit applications lacked a primary focus on assessing performance fundamentals and that banks' priorities appeared to have shifted excessively to squeezing out credit risk in their assessment of many cases. The report noted that this was particularly evident in micro enterprise and the smaller end of the medium business sector.

#### *Appeal Applications to the CRO*

**3.55** From 1 April 2010 to end March 2012, the CRO received a total of 197 review applications.<sup>30</sup> Of these, the CRO had made a decision in 117 cases, of which the banks' decision was upheld in 41% of cases – the lending requested in those cases amounted to €4.1 million. The banks' decision was disputed by the CRO in 59% of cases and credit was subsequently provided by the banks. The credit sought in these cases amounted to €6.9 million. In a further 16 cases, the banks' internal appeal procedures had overturned the original refusal and credit had been provided.

**3.56** In 64 instances, the applications were awaiting an eligibility decision, were proceeding through the review process or had been withdrawn.

#### ***SME Lending Demand Study***

**3.57** In July 2012, the Department published a report, the ***SME Lending Demand Study***, which presented the results of a survey of 1,500 SMEs. The survey covered the period from October 2011 to March 2012. An earlier survey had covered the period from April 2011 to September 2011. The conclusions from the 2011/2012 survey included the following

- 38% of those surveyed had requested credit of which 28% were declined (excluding those where a decision was pending).
- Criteria and conditions for approval remained largely similar to those found by the previous study, with respondents indicating that the requirement to maintain regular management accounts and the provision of personal guarantees were the conditions most frequently stipulated by banks.
- In 81% of cases where a formal application for credit was declined, the SME applicant did not agree with the reason provided by the bank.
- The timeframe associated with banks making credit decisions was continuing to lengthen. The code of conduct requires lenders to notify an SME of a decision within 15 business days of receiving all information to support the request. The study suggested that only 60% of applications are processed within 15 working days. The report noted that this is construed as a constructive refusal which can be reviewed by the CRO.

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30 96 applications were in respect of AIB and 101 were in respect of Bank of Ireland.

- In the main, where it is being sought, credit is requested by SMEs to fund working capital and cash flow rather than to invest in company development, expansion, capital investment or entry into new markets. The report noted that this is a continuing trend and may, in the long term, represent a risk to the economic viability of these entities if survival and consolidation, rather than development and expansion, remain the focus. The report also noted that it is apparent that a bank is more likely to decline a request for development and expansion purposes than for working capital purposes, thereby reducing the incentive for an SME to apply for development-type credit.
- Although base numbers were low, it was apparent that banks were more likely to refuse growth or expansion-related borrowing proposals from micro SMEs than for other SMEs.<sup>31</sup> For this reason, the report suggested that alternative sources of capital for expansion and growth type activities of micro SMEs are required.

**3.58** In June 2012, the Minister for Jobs, Enterprise and Innovation published the Microenterprise Loan Fund Bill 2012, under which it is proposed a Microenterprise Loan Fund Scheme will be established. The Department of Jobs, Enterprise and Innovation stated that the scheme, which is expected to be operational from early autumn 2012, would initially facilitate €40 million in additional lending over the next five years to businesses employing not more than 10 people.

**3.59** The Credit Guarantee Act 2012 which came into force in July 2012, provides for a credit guarantee scheme for SMEs.

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<sup>31</sup> A micro enterprise has less than ten employees.

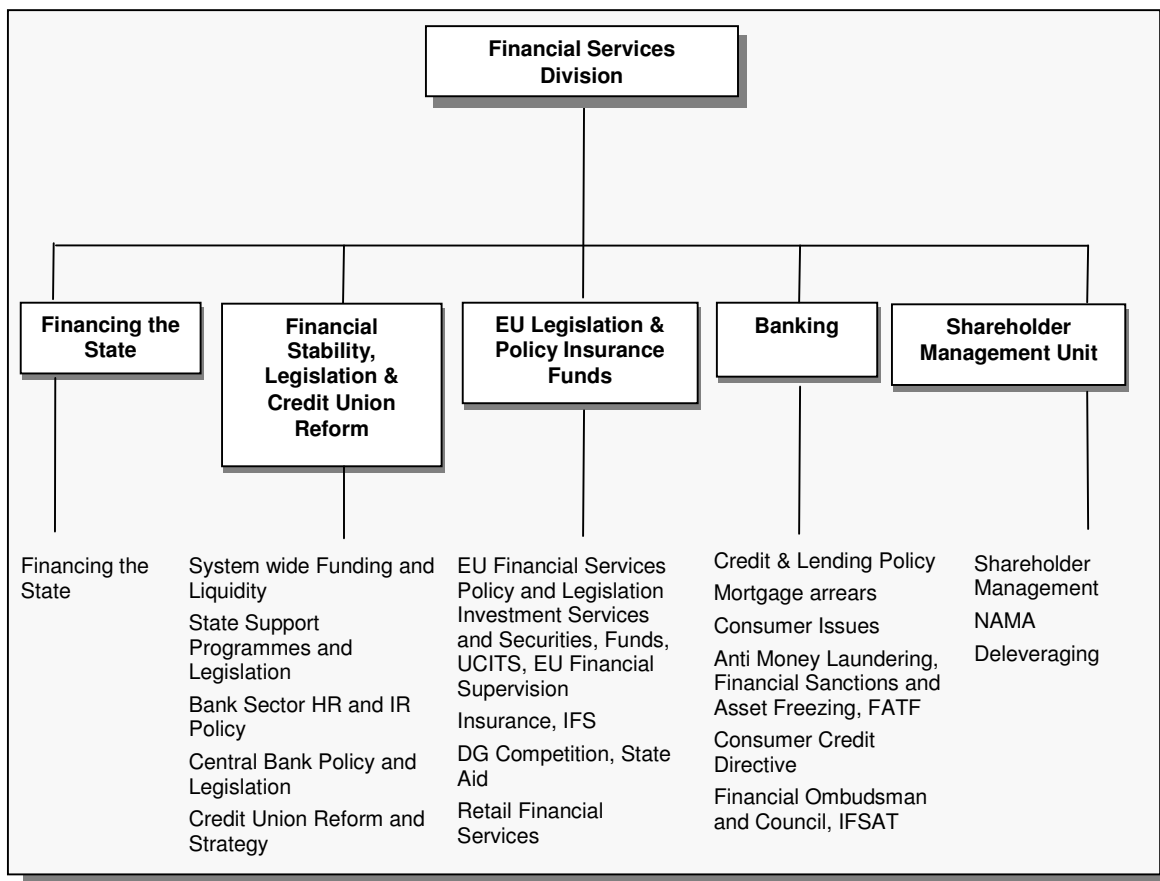
## Framework for Managing the State’s Investments

**3.60** Both the Department and the Central Bank have responsibilities in relation to banking oversight. Overall responsibility for managing the State’s investment in financial institutions lies with the Department.

### Financial Services Division

**3.61** In March 2010, the Minister delegated certain banking functions to the NTMA.<sup>32</sup> The NTMA established a dedicated banking unit to carry out this function. In August 2011, the delegation order was revoked and those banking functions are now the responsibility of the Department.<sup>33</sup> The Department established a Banking Division to focus on banking-related issues and to manage the State’s interest in the financial institutions that have received financial support from the State. The NTMA banking unit was seconded to the Banking Division in the Department.<sup>34</sup> Following the appointment of a new Secretary General in 2012, a further reorganisation incorporated the banking division into the Financial Services Division. The structure and function of the Financial Services Division is outlined in Figure 3.5.

**Figure 3.5 Department of Finance Financial Services Division Structure and Role July 2012**



Source: Department of Finance

<sup>32</sup> Statutory Instrument 115 of 2010, National Treasury Management Agency Act 1990 (Delegation of Banking System Functions) Order 2010 and a Ministerial direction of 19 March 2010 in relation to the NTMA’s functions under the statutory instrument.

<sup>33</sup> Statutory Instrument 395 of 2011.

<sup>34</sup> Costs incurred by the NTMA in respect of banking unit staff in the period August to December 2011 was €6.3 million.

- 3.62** In the period since the 2008 guarantee scheme for banks in Ireland was approved, there have been a number of EU Commission approvals (some temporary) for recapitalisation and restructuring plans of covered institutions. Assistance provided was required to be consistent with EU State Aid rules (see Figure 3.6)

**Figure 3.6 EU Provision on State Aid for Banking**

Article 107 of the EU Treaty provides that State aid is, in principle, incompatible with the common market. However, the article also provides that aid that remedies a 'serious disturbance in the economy' can be approved by the European Commission. The Commission's Banking Communication of October 2008 set out three criteria that must be met before approval will be granted. The aid must be

- appropriate – well targeted in order to achieve effectively the objective of remedying a serious disturbance in the economy
- necessary – the minimum amount necessary to reach the objective
- proportionate – designed in such a way as to minimise negative spill-over effects on competitors, other sectors and other member states.

In relation to nationalisation of banks, state aid approval is not necessary because under EU rules, the Commission does not distinguish between ownership of banks i.e. whether private or State investment. However, even with full State ownership, any subsequent recapitalisation requires EU approval.

When approval is received, there can be conditions attached e.g. implementation of a restructuring plan and the Commission, through the Director General of Competition, oversees compliance with conditions.

### ***Relationship Frameworks***

- 3.63** The Memorandum of Economic and Financial Policies of February 2012 agreed in the context of the EU/IMF programme committed the State to the finalisation of relationship frameworks with the covered banks in order to ensure that their core businesses would be run on a commercial, cost effective and independent basis to ensure the value of the banks as an asset to the State.
- 3.64** On 30 March 2012, the Department published relationship frameworks for each of the banks in which the State has acquired an interest in the context of the financial crisis – AIB, Bank of Ireland, Irish Life and Permanent and IBRC. The purpose of the frameworks is to provide the basis on which the relationship between the Minister and the banks is governed. The frameworks confirm that existing obligations imposed upon each of the banks under legislation and existing agreements between the State and each bank continue to apply.
- 3.65** The frameworks also provide that each bank will continue to operate at arm's length from the State. Each will have its own independent board and management team with independent powers of decision. In addition, the board of each bank will determine the bank's strategy and commercial policy including the adoption of its business plan and budget. The State will not intervene in the day-to-day operations of the banks or their management decisions including pricing and lending decisions.

**3.66** The relationship frameworks identify the actions for which Ministerial consent is required, when the banks must consult with the Minister and when they have an obligation to notify the Minister. The Department stated that the frameworks are proportional to the size of the State's shareholding in each bank. A summary is provided in Figure 3.7.

**3.67** Key provisions include

- IBRC requires consent from the Minister prior to undertaking a significant number of actions.
- AIB and Irish Life and Permanent are required to consult with the Minister on a wide range of issues but Ministerial consent is required only for the appointment or removal of the Chairman or the Chief Executive Officer.
- The Bank of Ireland framework provides for less extensive consultation with the Minister.

**Figure 3.7 Relationship Frameworks for Banks**

Issue	AIB and Irish Life and Permanent	IBRC	Bank of Ireland
Appointment / removal of Chairman or CEO	Consent	Consent	N/A
Appointments to the Board	<i>Consult</i>	Consent	N/A
Senior executive appointments	Notify	Consent	N/A
Certain remuneration related issues	N/A	Consent	N/A
Material transactions	<i>Consult</i>	Consent	N/A
Certain other reserved matters such as transactions other than on a normal arm's length basis or certain legal proceedings	<i>Consult</i>	Consent	N/A
Annual updating and adjustment of the business plan	<i>Consult</i>	<i>Consult</i>	Notify
Sectoral lending policy	<i>Consult</i>	N/A	Notify
Other material matters	Notify	Notify	N/A

Source: Department of Finance

Note: N/A indicates that the issue is not provided for in the relationship framework.

### ***Appointment of Bank Auditors***

**3.68** A key governance issue for the financial institutions is the appointment of auditors. This is a matter for their Boards and the relationship frameworks do not give the Minister any role in the matter.

**3.69** In response to concerns that the independence of auditors may be threatened by the fees to be earned from the provision of non-audit services and by familiarity with clients arising from reappointment of the same auditor firms for long periods, the European Commission published a draft regulation on auditing in November 2011. This proposes, inter alia, that

- There would be a prohibition on the provision of non-audit services by firms carrying out the audit of public interest entities.<sup>35</sup> This is designed to address the need to reinforce audit independence and professional scepticism.

<sup>35</sup> Public interest entities are those that are of significant public relevance because of the nature of their business, their size or their number of employees, in particular companies whose securities are admitted to trading on a regulated market, banks and other financial institutions and insurance undertakings.

- There would be mandatory rotation of audit firms after a maximum period of 6 years (or 9 years where there are joint auditors) with a view to addressing the threat of familiarity that results from public interest entities appointing and re-appointing the same audit firm for decades.

**3.70** The Commission proposals are proceeding through the legislative process at EU level and the regulation will not come into force until 2013 at the earliest.

### **Exchequer Advances to the Insurance Compensation Fund**

**3.71** The Insurance Compensation Fund was established under the Insurance Act, 1964 to make arrangements to meet certain liabilities of insolvent insurers.<sup>36</sup> The Act provides for the Minister to make grants and loans to the Fund and for contributions to the Fund by insurers.

**3.72** The Fund is maintained and administered under the control of the President of the High Court acting through the Accountant of the Courts of Justice. Amounts are paid from the Fund, with the approval of the High Court, to a person in relation to an insurer in liquidation or administration, in respect of claims under policies issued by the insolvent insurer in circumstances where it seems unlikely that the claims can be met otherwise.

**3.73** The Accountant is, in respect of the amount paid out of the Fund, a creditor of the insolvent insurer which has received the funds. The Accountant provides a statement on the Fund to the Department and the Central Bank annually.

**3.74** In the period since the early 1980s, the Fund has advanced monies to Primor plc (formerly PMPA Insurance Company) and Icarom plc (formerly Insurance Corporation of Ireland). At the end of 2010, the Fund statement showed that it had debtors amounting to €381 million (Primor plc €150 million and Icarom plc €231 million). During 2011, the Fund advanced a further €11 million to Icarom plc, and Primor plc returned €10 million in unused funds following which the Fund held €40 million in assets.<sup>37</sup>

### ***Sale of Quinn Insurance Business***

**3.75** In March 2010, by order of the High Court following an application by the Financial Regulator, joint administrators were appointed to Quinn Insurance Limited (QIL).

**3.76** In April 2011, the joint administrators agreed to sell the Irish business of QIL to Liberty Mutual Direct Insurance Company Limited (Liberty Direct), a joint venture between Liberty Mutual and Tutelana Ltd. The latter is, in turn, a joint venture between IBRC and QIL. The sale transaction provided that Liberty Direct's total investment would be capped at €102 million with an additional €98 million investment from Tutelana Ltd. Under the agreement, Liberty Direct assumed liabilities of €51 million in excess of the assets transferred to it by QIL – referred to as the target deficit.<sup>38</sup>

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<sup>36</sup> The 1964 Act was amended in 2011. Payments to companies that entered administration before the Act was amended are made under the original provisions of the 1964 Act.

<sup>37</sup> The Fund received a contribution from AIB for the same amount.

<sup>38</sup> Total liabilities were estimated to be around €860 million.

- 3.77** Ultimately, the liabilities of QIL at the time of transfer will be determined by the level of claims on policies written by QIL prior to the transfer. When the sale was agreed, it was envisaged that within three months of the sale being completed, a review of the liabilities would be carried out and any necessary financial adjustments made in order to ensure that the net liabilities equalled the target deficit. The joint administrators, however, subsequently negotiated revised terms of sale with Liberty Direct whereby, over a 36 month period, there would be quarterly reviews of the transferred Irish book. If reserves are deemed to be inadequate during this time, then QIL (and ultimately the Fund) will be required to put in extra funding. At the end of this period, there will be what is referred to as a 'true-up', i.e. any shortfall in the overall reserves to meet the claims obligations will be met by a payment from QIL to Liberty Direct or, if excess reserves have been paid to Liberty Direct, it will be required to make a refund.
- 3.78** As part of the sale agreement, all employees of QIL transferred to Liberty Direct, and Liberty Direct provides services to QIL in relation to its policies in Northern Ireland and the UK. Under the terms of the sale agreement, Liberty Direct has an option, exercisable at any time until December 2012, to acquire the renewal rights to the UK and Northern Ireland policies.
- 3.79** In October 2011, the High Court approved the sale of QIL's Irish business to Liberty Direct. The joint administrators reported to the High Court that the sale closed on 11 November 2011.

#### ***Advances from the Insurance Compensation Fund***

- 3.80** The actuarial process of estimating the liabilities expected to arise in respect of future liabilities is referred to as reserving. In the case of QIL, any shortfall between reserves and assets will be met from the Fund in respect of
- claims arising on Irish policies up to the date of the sale to Liberty Direct and
  - claims on policies written in the UK and Northern Ireland until such time as the business ceases or is sold to another party.
- 3.81** The joint administrators have provided the High Court on a number of occasions with estimates of the total amounts that QIL may require from the Fund. In October 2011, the joint administrators informed the High Court that an estimated €738 million would be required from the Fund. In December 2011, when the joint administrators made a further report to the High Court, the estimate was revised upwards by €37 million to €775 million.
- 3.82** In July 2012, the joint administrators made a further report to the High Court in which they stated that the previous estimate of €775 million had increased to a possible requirement for €1,650 million due to
- an increase in the best estimate by the actuaries of the ultimate claims cost (an additional €208 million)
  - inclusion of a further €300 million as an 'adverse deviation provision' in reserves
  - a provision of €215 million against currency movements and
  - a further €152 million in respect of a write-down of the QIL investment in Tutelana Ltd, an expected decrease in asset values and higher trading losses in the future.

However, the joint administrators stated that if they were to remove the various accounting adjustments they had made and instead use a 'best estimate' calculation, then the call on the Fund was likely to be in the range of €1.1 billion to €1.3 billion.

- 3.83** In the July 2012 report, the joint administrators also indicated that they wished to cease underwriting business in the UK and Northern Ireland but that they were obliged to continue underwriting until Liberty Direct either exercised its option to acquire the renewal rights to those businesses or the option period expired at the end of December 2012.

### ***Funding by the State***

- 3.84** In accordance with Section 5 of the 1964 Act, in the event that the Fund does not have sufficient funds to meet a payment approved by the High Court, the Minister may, on the recommendation of the Central Bank, advance monies to the Fund from the Exchequer to enable payments out of the Fund to be made promptly and on the terms and conditions that he decides to be appropriate.
- 3.85** By the end of June 2012, €786 million had been advanced from the Fund to QIL while the State had lent almost €730 million to the Fund (see Figure 3.8).

**Figure 3.8 Insurance Compensation Fund Transfers October 2011 to June 2012**

<b>Date of Approval by the High Court</b>	<b>Date of Payment</b>	<b>Total Transfer</b>	<b>Exchequer</b>
		<b>to QIL</b>	<b>Loans</b>
		<b>€ million</b>	<b>€ million</b>
October 2011	November 2011	320	280
December 2011	January 2012	210	210
December 2011	March 2012	40	40
March 2012	April 2012	166	166
March 2012	August 2012	50	34
	<b>Total<sup>a</sup></b>	<b>786</b>	<b>730</b>

Source: Department of Finance (rounded to € million)

Note: a The difference of €56 million between the loans from the Exchequer and the amount transferred to QIL was funded by €40 million in the Fund at the time of the initial advance (November 2011) and levy contributions of €16 million from the first quarter of 2012.

### ***Insurance Premiums***

- 3.86** The Central Bank has responsibility under the 1964 Act (as amended) for determining whether the Fund requires financial support and the level of any contribution to be paid to the Fund by insurers. The contribution may not exceed 2% of the gross premiums paid to each insurer for policies issued in respect of risks in the State. While the Act provides that insurers are liable to pay the levy, in practice it is passed on to policyholders.
- 3.87** A levy came into effect on 1 January 2012. The Central Bank set the levy at the maximum 2% of the gross premiums paid. The Department estimates that the levy will generate approximately €65 million per annum. The levy sums are payable quarterly in arrears by insurers to the Revenue Commissioners who have responsibility for its collection and subsequent transfer to the Fund.

## Conclusions

### *Investments in financial institutions*

- 3.88** The State has provided enormous financial support for the banking sector. By mid-2012, the State had made an investment of just over €65 billion in four Irish financial institutions. The State now owns all, or almost all, of Allied Irish Bank, Permanent TSB and IBRC while it owns 15% of Bank of Ireland.
- 3.89** By the end of June 2012, the State has received a financial return of around €4.3 billion in cash from the stabilisation measures – over €0.9 billion from the investments in the banks and almost €3.4 billion in fees from the liability guarantee schemes. An additional €1.1 billion was payable as dividends but was received in the form of ordinary shares.
- 3.90** While no timeframe has been set for the State's withdrawal from its ownership of banks, there is a prospect that the State may in time recover some of its capital investment. The core tier one capital of the banks (excluding IBRC) is projected to be between €13.7 billion and €21.4 billion by the end of 2013. The adequacy of the capital injected by the State to meet the banks' capital requirements depends on the net losses incurred by the three banks in the period 2011 to 2013 not exceeding those projections by the Central Bank.
- 3.91** The amount recouped from the purchase of Irish Life, for which the State paid €1.3 billion, will be primarily dependent on the financial performance of the company and market conditions when it is sold. The residual value in IBRC, if any, will depend on both its financial performance and the amounts realised from the disposal of its assets.

### *Advances to Insurance Compensation Fund*

- 3.92** A significant additional funding requirement for the Exchequer arises from the administration of QIL, which has a requirement for funding currently projected at up to €1.65 billion. Up to the end of June 2012, a total of just under €730 million had been advanced from the Exchequer to the Insurance Compensation Fund to allow it to meet its obligations in relation to QIL. While levy receipts on insurance sales will ultimately be available to repay the Exchequer, substantial additional advances are likely to be required in the short to medium term.

### *Deleveraging*

- 3.93** At the end of 2011, AIB and Bank of Ireland had achieved interim LDR targets that had been set by the Central Bank. They reduced their LDRs further by mid-2012. A decision was taken to postpone the disposal of a subsidiary of Irish Life and Permanent and it did not achieve its interim LDR target for 2011.
- 3.94** Some of the steps taken by the banks to achieve these target ratios may be having unintended consequences - both the Department and a report by the IMF noted that the amount of deleveraging of core assets (loans in the domestic economy) was higher than targeted. The IMF report also noted that increased deposit interest rates had undermined bank income, and that potential large scale deleveraging by European banks may reduce the prices at which assets can be sold in the deleveraging process.

- 3.95** The Department has indicated that excessive deleveraging of core portfolios will be avoided so as not to impair the flow of credit to the economy. It is intended that banks' deleveraging will be assessed based on existing nominal targets for reduction in non core assets in line with the 2011 Financial Measures Programme and an advanced monitoring framework for funding and liquidity will be established.

#### ***Ongoing requirement for liquidity support***

- 3.96** State financial support has facilitated the restructuring of the banking system and the solvency of the institutions in which the investments have been made. Deleveraging of the banks has also improved the stability of their funding position. Nevertheless, the banks continue to depend on liquidity support from the State and the ECB. In mid-2012, liquidity support for the covered institutions advanced by the Central Bank through Eurosystem monetary policy operations and by way of exceptional liquidity assistance stood at over €106 billion. In addition, the State had guaranteed liabilities and deposits of covered financial institutions to a total of €164 billion at the end of June 2012.

#### ***Lending to small and medium enterprises***

- 3.97** Review of credit availability for small and medium enterprises suggest that there are continuing difficulties in that regard and that normal access to credit has not been restored.
- 3.98** While the two main banks have been meeting lending targets set as a requirement of their recapitalisation by the State, an IMF report following a review of the EU/IMF programme noted that the faster than planned run-off of the Irish banks' core portfolios potentially constrained domestic credit. In addition, reports by the Credit Review Office and a study of lending demand conducted on behalf of the Department of Finance highlight continuing difficulties experienced by smaller enterprises in obtaining credit, and that the bulk of lending is for working capital rather than for development and expansion. Recent policy initiatives may help to address credit availability for small and medium enterprises.
- 3.99** Given the apparent capacity of the main banks to comply with lending targets while lending difficulties persist for businesses, the usefulness of setting performance targets for the banks in terms of gross lending to SMEs as a measure of credit availability may be limited.