

Chapter 6

Central Government

Banking Stabilisation Measures

Banking Stabilisation Measures

6.1 The ongoing crisis in global financial markets and the structural weaknesses it exposed in the Irish banking sector continue to require concerted policy, regulatory and public finance responses. The initial responses to the crisis — in late 2008 and early 2009 — focused on containment of the problem, primarily through liquidity support and guarantees for bank liabilities. Since then, policy responses have focused more on resolution of underlying systemic problems, through a range of measures to restructure banks and encourage bank lending, including purchase of distressed loans, ongoing guarantees of banking liabilities and injections of capital. Measures have also been taken to address the failures in regulation and in oversight of the financial sector that contributed to the severity of the impact in Ireland of the global financial crisis.

6.2 Some of the banking stabilisation measures that were implemented have resulted in expenditure of substantial public funds, or the taking on of commitments to future expenditure. Other measures give rise to significant contingent liabilities.

Chapter Focus

The measures implemented have involved action by the Department of Finance, the Central Bank, the Financial Regulator, the National Treasury Management Agency and the National Pension Reserve Fund. The financial transactions involved and commitments entered into are (or will be) accounted for in a variety of ways. This chapter has been compiled to present an overview of the main measures implemented, and of the financial impacts to date, including financial commitments and contingent liabilities.

Importance of Banking Stability

6.3 Banks are vital to the functioning of the economy. The deposits they hold are a key part of the payment mechanism for households and businesses, and by allocating savings to borrowers, they promote economic growth. The failure of a major bank has the potential to leave individuals and businesses unable to access savings, raise finance or meet ongoing payments. System wide failures in the banking sector cannot but cause very significant negative effects on the wider economy.

6.4 Banks are vulnerable in two main ways

- a combination of short-term (liquid) liabilities and longer term (illiquid) assets creates a risk of liquidity shortage
- a decline in the value of their assets can have a disproportionately large effect on a bank's capital (since impairments can only be met out of accumulated reserves).

6.5 When such liquidity or solvency issues arise, governments and/or central banks acting as guardians of the public interest, need to intervene in order to protect the stability of the whole financial system and at the same time try to avoid major negative repercussions for the real economy. This intervention can take various forms ranging from deposit insurance schemes and the function of the lender of last resort undertaken by the central bank in order to address liquidity as well as State sponsored purchases of distressed assets and outright capital injections to address solvency issues.

Liquidity Support Measures

6.6 The main State mechanisms for provision of liquidity support to banks have been schemes guaranteeing certain classes of banking liabilities. In addition, the Central Bank has extended collateral-based credit to Irish banks under European Central Bank Eurosystem rules.

Guarantees of Banking Liabilities

6.7 State backed guarantees over banking liabilities have been put in place under three main schemes. These were

- extension of the existing Deposit Guarantee Scheme, announced on 20 September 2008, to address apparent consumer concerns about the security of their deposits in credit institutions
- provision of a two-year State guarantee in respect of a wide range of bank liabilities, announced on 30 September 2008 (the CIFS Bank Guarantee scheme)
- a State guarantee scheme put in place on 9 December 2009, providing for cover for a narrower range of banking liabilities but with maturities of up to five years, mirroring schemes put in place by other European states and approved under EU State aid rules (the Eligible Liabilities Guarantee scheme).

Deposit Guarantee Scheme

6.8 All credit institutions licensed to receive deposits in Ireland are required to participate in the Deposit Guarantee Scheme. As a means of enhancing the security of deposits and encouraging consumers to retain funds in Irish institutions, the compensation limit under the scheme was increased in September 2008 from €20,000 to €100,000 per eligible depositor per institution³³.

6.9 Credit institutions subject to the provisions of the scheme are required to deposit funds in a Deposit Protection Account administered by the Central Bank. The required deposit is 0.2% of the total value of current customer deposits with the institution — not just of the value of deposits guaranteed. In the event of the liquidation of a credit institution, claims by depositors would be met in the first instance by the Central Bank, using the resources of the Deposit Protection Account. Any shortfall would 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.

6.10 At end 2009, around 50 credit institutions were subject to the provisions of the scheme. The balance in the Deposit Protection Account was €608 million (by comparison with €26 million at the end of 2007 and €69 million at the end of 2008).

6.11 Up to September 2008, credit unions had not been covered by the scheme. The extension of the scheme included a provision that credit union deposits would subsequently be covered, and the legislation provided for this. However, an order has not yet been made requiring credit unions to hold funds in the Deposit Protection Account. Discussion is still ongoing about the level of funding that credit unions will be required to hold in the account.

³³ The legal basis for the change was provided through the Financial Services (Deposit Guarantee Scheme) Act 2009.

CIFS Bank Guarantee Scheme

6.12 The Credit Institutions (Financial Support) Scheme (referred to as the CIFS Bank Guarantee scheme) was announced on 30 September 2008³⁴. Participation in the scheme was voluntary (subject to certain terms and conditions), and seven credit institutions (including certain subsidiaries) opted to avail of it³⁵.

6.13 The scheme provided a temporary State guarantee — until 29 September 2010 — for a broad range of liabilities of the covered institutions at 30 September 2008, or incurred by them during the guarantee period. These include

- all deposits with the covered institutions, to the extent that they are not covered by the Deposit Guarantee Scheme
- senior unsecured debt
- asset-covered securities and
- dated subordinated debt.

Asset-covered securities and dated subordinated debt issued after the credit institutions concerned joined the Eligible Liabilities Guarantee scheme are not covered by the CIFS scheme.

6.14 Institutions participating in the scheme are required to make quarterly payments to compensate the State for the impact of the scheme on the cost of State borrowing.

6.15 The overall sum to be recovered through the payments is based on the estimated increased cost of funding Government debt as a result of the provision of the CIFS guarantee. In practice, it is not readily possible to separate the impact of the guarantee on Government funding costs from the impact of other factors. In arriving at the sum, account was also taken of the combined capacity of the covered institutions to pay the charges, given the circumstances that gave rise to the need to introduce the guarantee. Based on the advice of the National Treasury Management Agency, the Department of Finance concluded the cost of funding Government debt increased by between 0.15% and 0.3% as a result of the guarantee. On that basis, the Department determined that the sum to be collected from the covered institutions should be €1 billion over two years.

6.16 The model used for calculating the distribution of the charge between the institutions covered by the guarantee was based on long-term credit ratings as indicators of the risk profiles of the individual institutions. Each institution is required to calculate the amount to be paid each quarter, and to have the amount verified by the institutions' external auditors.

6.17 A special account was set up at the Central Bank into which payments by the covered institutions under the CIFS scheme are lodged. This balance is being held as a reserve for any payments to be made under the scheme. Any balance remaining at the expiry of the scheme will be paid to the Exchequer.

³⁴ 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.

³⁵ AIB, Bank of Ireland, Anglo Irish Bank, Irish Life and Permanent, Irish Nationwide Building Society, Educational Building Society, and PostBank.

6.18 Figure 23 indicates the amount paid into the CIFS scheme account since the inception of the scheme. Up to the end of July 2010, a total of €730 million had been received.

Figure 23 Payments by covered institutions under the CIFS Banking Guarantee Scheme, for Quarter 4 2008 to Quarter 2 2010

	Payments
	€m
Quarter 4 2008	110
Quarter 1 2009	115
Quarter 2 2009	70
Quarter 3 2009	76
Quarter 4 2009	177
Quarter 1 2010	170
Quarter 2 2010	12
	730

Source: Department of Finance

6.19 The CIFS scheme provides for the Minister for Finance, at his discretion, to review the charges levied on covered institutions. In light of the amounts paid in respect of the period to June 2009 (a total of €295 million), the charges were reviewed and adjusted upwards in September 2009. As a result, the charges in respect of the last quarter of 2009 were more than double the level paid for the quarter ending in September 2009.

6.20 The CIFS payment system was further amended to align the scheme charges with those under the Eligible Liabilities Guarantee scheme. This included moving from payment in advance, based on estimated covered liabilities, to payment in arrears based on actual covered liabilities. This, coupled with a substantial movement of covered liabilities to the Eligible Liabilities Guarantee scheme, resulted in a reduced payment level (€12 million) for Quarter 2 2010.

Eligible Liabilities Guarantee

6.21 The Eligible Liabilities Guarantee scheme was introduced in December 2009. It is designed to provide a longer term guarantee of certain banking liabilities, and to bring the Irish bank guarantee structure more into line with guarantees in other EU member states.

6.22 The scheme is being administered by the National Treasury Management Agency, on behalf of the Minister. The Agency has approved the participation of six of the credit institutions covered under the CIFS Banking Guarantee Scheme (and certain of their subsidiaries) in the new scheme. In joining it, the participating credit institutions effectively relinquished the right to issue or incur new liabilities under the CIFS scheme.

6.23 Following approval under EU State aid rules, the Eligible Liabilities Guarantee scheme initially provided for participating credit institutions, in the period up to the end of June 2010, to issue eligible debt securities and to take deposits with a maturity of up to five years, on either a guaranteed or non-guaranteed basis. New dated subordinated debt and asset-covered securities issued after a participating institution joined the scheme are not eligible for guarantee cover.

6.24 On 29 June 2010, the EU Commission approved a prolongation of the period during which liabilities could receive cover. As a result, participating credit institutions can apply for and receive guarantee cover

- until 29 September 2010, for new corporate deposits and new debt liabilities with maturities up to three months
- until 31 December 2010, for other new eligible liabilities with maturities up to five years.

6.25 The institutions participating in the Eligible Liabilities Guarantee scheme pay a fee for the cover they receive, but at a higher level than provided for under the CIFS scheme. The pricing is designed to encourage the institutions to reduce their reliance on State support over time.

6.26 The payment level for liabilities depends on factors such as the maturity profile and amount of the liabilities, and is based on European Central Bank recommendations on pricing government guarantees of banking liabilities. For instance, an annualised fee of 0.5% applies to short-term debt (i.e. with a maturity up to one year). For longer-maturity debts, an additional fee (based on the credit default swap rating of the institution prior to the banking crisis) is also applied. Since 1 July 2010, further additional fees of between 0.2% and 0.4% (depending on the credit rating of the institution) apply on all covered liabilities.

6.27 Up to the end of July 2010, a total of €296 million had been collected from institutions for participation in the scheme. Payments accrue to the Exchequer on an ongoing basis and will not be held in a reserve.

Aggregate Value of Covered Liabilities

6.28 The three guarantee schemes operate in parallel for the covered institutions. Figure 24 indicates the estimated total value of the liabilities covered by the schemes at the end of each quarter from December 2008 to March 2010.

Figure 24 Estimated value of guaranteed liabilities of covered credit institutions, December 2008 to March 2010

	Banking liabilities covered by			Total value of guaranteed liabilities € billion
	Deposit Guarantee ^a	CIFS Bank Guarantee	Eligible Liabilities Guarantee	
	€ billion	€ billion		
End Quarter 4 2008	82	346	—	428
End Quarter 1 2009	79	293	—	372
End Quarter 2 2009	79	276	—	355
End Quarter 3 2009	78	287	—	365
End Quarter 4 2009	77	281	—	359
End Quarter 1 2010	77	130	139	346
End Quarter 2 2010	78	103	153	334

Source: Department of Finance

Note:

a Relates only to eligible deposits in the institutions covered by the CIFS Bank Guarantee Scheme.

Central Bank Liquidity Support

6.29 The Central Bank, through its participation in Eurosystem monetary policy operations, has provided substantial funding to support the liquidity of the banking sector, in the form of advances to credit institutions based in Ireland (including credit institutions based in the Irish Financial Services Centre). All the advances are secured by collateral approved by the Eurosystem, which broadened the type of assets acceptable as collateral in 2008. Key ECB interest rates were reduced between October 2008 and June 2009. In practice, the Central Bank/Eurosystem has, since October 2008, provided as much liquidity as banks sought³⁶.

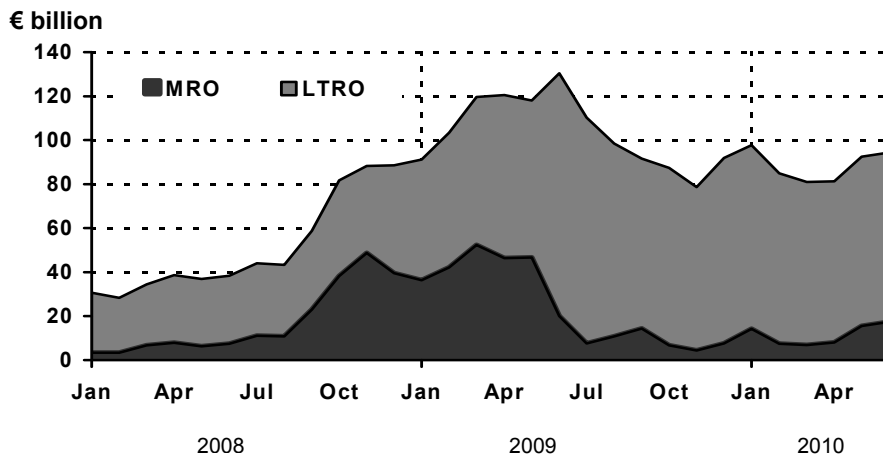
6.30 Advances under the Eurosystem fall into two broad categories

- The Main Refinancing Operations (MRO) comprise weekly offers of loans with a maturity of one week and (since October 2008) at fixed interest rates
- The Long Term Refinancing Operations (LTRO) comprise mainly monthly offers of loans with a maturity of three months and (since October 2008) also at fixed interest rates.

6.31 In 2008, LTRO loans with a maturity of six months were added as a temporary measure. In 2009, LTRO loans with a maturity of twelve months were added. The extended maturity LTRO loans issued in December 2009 (one-year maturity) and March 2010 (six-month maturity) were scheduled to be the last such facilities.

6.32 As Figure 25 indicates, Central Bank Eurosystem lending to credit institutions increased significantly from €38 billion at the end of June 2008, to a peak of around €130 billion at the end of June 2009. Since then, the level of liquidity support provided has fallen, fluctuating in the range €80 billion to €100 billion since August 2009.

Figure 25 Central Bank/Eurosystem Lending to Credit Institutions, January 2008 to June 2010



Source: Central Bank Monthly Statistics Bulletins

6.33 Both retail and international banks avail of Eurosystem liquidity. The Central Bank has reported that over 65% of the lending at end March 2010 was to banks with an important retail

³⁶ The level of Eurosystem lending is limited, however, by the amount of available eligible collateral held by banks.

presence in Ireland and undertaking significant business with households and non-financial corporate customers.

Special Liquidity Facilities

6.34 In addition to liquidity provision within the Eurosystem operations, the Central Bank also provides special liquidity facilities where required. At end 2009, the Central Bank's balance sheet reported 'other assets' totalling €12.8 billion, up from €729 million at the end of 2008. The increase primarily reflected the provision of special liquidity facilities.

6.35 On 30 September 2008, the Minister for Finance issued a letter of comfort in support of Anglo Irish Bank's borrowings from the Central Bank under special liquidity arrangements.

Restructuring of Banks

6.36 A range of State-funded or promoted initiatives have been implemented to restructure banks with the aim of restoring confidence in their ability to operate as going concerns, and to resume normal lending. A key focus has been to achieve market-acceptable capital levels in the banks, in particular following the recognition by them of enormous losses incurred on their development and property loan portfolios on the transfer of these impaired assets to the National Asset Management Agency (NAMA).

6.37 As part of the EU State aid review process, the credit institutions being recapitalised by the State were required to draw up and submit restructuring plans to the European Commission. The plans must identify why the institutions ran into difficulty, and present a viability plan, a programme of burden sharing measures, and a programme of measures to limit distortion of competition. The recapitalised institutions submitted their plans on various dates between September 2009 and June 2010. A decision was received in respect of the Bank of Ireland plan on 15 July 2010. Dialogue with the EU is continuing in respect of the other plans.

Assessment of Capital Requirements

6.38 In early 2010, the Central Bank and Financial Regulator carried out reviews of the capital requirements of three credit institutions — Bank of Ireland, AIB and the Educational Building Society (EBS) — for the three years until 2012. Based on the results of the reviews (referred to as Prudential Capital Assessment Reviews) new capital levels were set for the institutions. The capital was set at levels designed to ensure that they can withstand future losses, even under very stressed conditions. The institutions were required to prepare recapitalisation plans to meet the capital levels by end 2010.

6.39 In order to calculate the capital requirements of individual institutions, the Financial Regulator specified a core tier 1 capital requirement of 8% of total assets to be attained by the end of 2010. This level of capital must be met after taking account of all future losses, from both NAMA and non-NAMA portfolios. This capital must be principally in the form of equity — a 7% equity requirement. Furthermore, banks could not go below a level of 4% core tier 1 capital even in a severely stressed scenario.

6.40 The capital assessment process was not completed for the other institutions participating in the State guarantee schemes. In two cases — Anglo Irish Bank and Irish Nationwide Building Society (INBS) — levels of capital needed to allow the institutions to meet the current minimum capital requirements were identified. In a statement on the results of this exercise, the Minister for Finance indicated that Anglo Irish Bank would require further capital to cover future losses.

6.41 Irish Life and Permanent was not included in the first round of capital assessments because it has not received a government capital injection and is not taking part in NAMA.

6.42 The identified additional capital requirements for individual credit institutions are summarised in Figure 26.

Figure 26 Summary of additional equity capital required, March 2010

Credit institution (State guaranteed)	Minimum equity capital requirement by end 2010
	€ billion
Bank of Ireland	2.7
AIB	7.4
Educational Building Society (EBS)	0.875
Anglo Irish Bank	18.3 ^a
Irish Nationwide Building Society (INBS)	2.6

Source: Financial Regulator

Note:

a Comprises €8.3 billion to meet capital requirements at end March 2010, and an estimated €10 billion to cover subsequent losses.

Purchase of Impaired Bank Assets

6.43 NAMA was established in December 2009. Its purpose is to acquire impaired property-related loans from banks (bank assets). The overall objective is to bring stability to the banking system by removing those loans from the balance sheets of banks.

6.44 The National Asset Management Agency Act 2009 (the Act) and associated regulations made by the Minister for Finance prescribe the types of bank assets that NAMA may acquire and how they are to be valued. Five financial institutions — those shown in Figure 26 above — applied to take part in the scheme, and all were designated as participating banks by the Minister.

6.45 Based on the Minister's direction, NAMA is purchasing eligible bank assets from participating banks at their long-term economic value. The purchase scheme required the approval of the EU Commission because it includes the provision of State aid to the participating banks. The Commission gave its approval for the establishment of NAMA on 26 February 2010. It has stated that it will reassess the aid granted in light of the adequacy of the actual notified asset transfers and restructuring plans which the banks are required to submit to the Commission. It must be notified of the transfer prices of the bank assets on an ongoing basis.

6.46 NAMA's business plan, published in June 2010, indicates that the Agency anticipates it will ultimately acquire about 15,000 loans made by banks to 1,500 borrowers, with an aggregate book value (including accrued interest) of around €31 billion. Figure 27 gives a breakdown of the target assets by participating credit institution, to be acquired in tranches. NAMA aims to transfer all the target assets by February 2011.

Figure 27 Estimated value of eligible assets for purchase by NAMA, by credit institution

Credit institution	Value of eligible assets € billion
Anglo Irish Bank	36
AIB	23
Bank of Ireland	12
Irish Nationwide Building Society	9
Educational Building Society	1
Total	81

Source: NAMA Business Plan, June 2010, page 20

6.47 The purchase of the first tranche of bank assets — loans to ten of the borrowers with the highest debt — was completed in May 2010. The cumulative value of the debts of these borrowers to the participating credit institutions was €5.3 billion (just under 19% of the target total). NAMA paid €7.7 billion for the loans — around 50% of the book value. For individual credit institutions, the amount paid represented discounts on the book value of the loans ranging from 35% to 58%. The amount paid for individual loans ranged from 0-100% of the book value.

6.48 The property associated with the acquired bank assets was valued at around €7.5 billion, which was uplifted by 11% to €8.3 billion after adjustment for long-term economic value.

6.49 The loans are acquired by a NAMA group entity, a majority privately owned special purpose vehicle called NAMA Asset Management Ltd. This entity issues debt to fund the consideration payable. Debt issued to pay for the first tranche of loans comprised

- €7.3 billion (95% of the total) in securities guaranteed by the Minister for Finance
- €0.4 billion in subordinated debt.
- The guaranteed securities pay interest at a variable rate, which is reset twice annually. The rate in the period to 1 September 2010 was just under 1%. The subordinated debt carries an interest rate linked to the yield on 10-year Irish Government bonds. Payment of interest on the subordinated debt and its ultimate redemption are dependent upon NAMA's financial performance.

6.50 A report on the acquisition of the first tranche of impaired bank assets by NAMA is in preparation. This will be published in Special Report number 76 of the Comptroller and Auditor General.

State Investment in Credit Institutions

6.51 Under legislative provisions in early 2009, the Minister for Finance directed the National Pension Reserve Fund Commission to invest €3.5 billion in preference shares of both Bank of Ireland and of AIB. In each case, the investment consisted of

- Perpetual non-cumulative preference shares³⁷ that pay a non-cumulative fixed dividend of 8%, payable at the respective banks' discretion in cash or with the equivalent value in ordinary shares. The preference shares can be repurchased by the bank at par value (€1 each) within the first five years and thereafter at €1.25 each.
- Warrants attach to the preference shares giving the Fund an option to subscribe³⁸ for ordinary share capital in the bank. The warrants are exercisable on the earlier of (i) anytime between the fifth and tenth anniversary of the date of the issue of the preference stock and (ii) in the event of an offer for the bank or other change of control.

6.52 In addition, on foot of the investment, the Minister can appoint 25% of the directors to each bank and the Fund receives 25% of total ordinary voting rights in respect of change of control and board appointments.

6.53 On 19 February 2010, Bank of Ireland paid a dividend of €250 million due on preference shares, in the form of ordinary shares in the bank. On 13 May 2010, AIB paid a dividend of €280 million due on its preference shares, in the form of ordinary shares of the bank.

6.54 In both cases, the payment was made in the form of ordinary shares because the European Commission had requested that discretionary coupon payments on tier 1 and upper tier 2 capital instruments³⁹ in Bank of Ireland and AIB not be paid while it considered each bank's restructuring plan. Following the issue of the shares, the Fund held 15.7% of the ordinary shares of Bank of Ireland and 18.6% of the ordinary shares of AIB⁴⁰.

6.55 In order to assist the two banks to meet the regulatory capital requirements identified by the Financial Regulator in the March 2010 recapitalisation exercise, the Minister for Finance announced that the State would support them in their capital raising.

- In the case of Bank of Ireland, this support would be provided through the conversion of part of the Fund's preference shares into ordinary shares.
- In the case of AIB, it would be provided by conversion of part or all of the Fund's preference shares (as required) into ordinary equity. If additional capital was required, it would be provided through investment in ordinary shares by the Commission.

³⁷ Preference shares are a type of share capital which confers particular rights, including priority payment of any dividend. The directed investments in Bank of Ireland and AIB preference shares rank *pari passu* (i.e. with equal rights) with ordinary shares in any liquidation, and the annual dividend ranks *pari passu* with dividend claims of other preference shares and ahead of ordinary share dividends.

³⁸ The exercise price for the Bank of Ireland warrants was set at €0.52 for 177,213,784 shares and €0.20 for 157,523,364 shares. The exercise price of AIB warrants is €0.975 for 155,780,375 shares and €0.375 for 138,471,444 shares.

³⁹ Tier 1 capital instruments refer to paid up share capital and common stock. Upper Tier 2 capital refers to certain subordinated debts including the preference shares held in the two banks.

⁴⁰ This includes small shareholdings already held in within the Funds discretionary investment portfolio.

6.56 In April 2010, Bank of Ireland announced a plan to raise €3.4 billion equity capital through a share placement and rights issue. The Commission was directed by the Minister to participate in the issue in accordance with the terms of a transaction agreement with Bank of Ireland. The financial impacts for the Fund arising from the deal are

- the Fund's ordinary shareholding in Bank of Ireland now stands at 36%, the market value of which at 30 June 2010 was €1.3 billion
- the par value of its remaining preference shares was €1.8 billion
- the Fund received €491 million in respect of the warrants issued in conjunction with the preference shares
- the Fund received €2 million in transaction fees.

6.57 AIB is continuing with its capital raising programme. No further financial outlays have been incurred by the Fund in respect of AIB to date.

Financial Support for Nationalised Credit Institutions

6.58 Since the emergence of the financial crisis in September 2008, three credit institutions — Anglo Irish Bank, INBS and EBS — have been taken into full State ownership. Substantial State expenditure has been incurred or committed in acquiring and supporting the continued operation of the three institutions.

Nationalisation of Anglo Irish Bank

6.59 The evident absence of market confidence in Anglo Irish Bank and growing concerns about the bank's governance resulted in a Government decision on 15 January 2009 to take the bank into State ownership.

6.60 The nationalisation was given effect through the Anglo Irish Bank Corporation Act 2009, which was signed into law on 21 January 2009. Since then, the bank has operated as a commercial semi-State body. It remains subject to regulation by the Financial Regulator and also remains a 'covered institution' under the terms of the guarantee scheme.

6.61 A detailed internal assessment of the Anglo Irish Bank loan book was carried out for the period leading up to the end of March 2009, and was reviewed independently by PricewaterhouseCoopers. As a result, it was recognised that there was very substantial impairment of certain loans, resulting in the bank's half year accounts published at the end of May 2009 showing pre-tax losses of €4.1 billion.

6.62 In the light of the losses, the Minister announced that, subject to EU approval, he would provide up to €4 billion of capital for the bank. Part of the injection of capital was to be used by the bank to buy back certain outstanding subordinated loans from bondholders at a significant discount on their par value. EU approval for the Government's capital injection was received on 26 June 2009.

6.63 During 2009, the Government provided the capital to the bank through the purchase of ordinary shares in the bank. The sum of €4 billion was paid out of the Central Fund, under Section 6 (9) of the Credit Institutions (Financial Support) Act 2008.

6.64 The subsequent recognition of further losses on the bank's lending portfolio during 2009 and in 2010 resulted in a requirement for the State to provide additional financial support to keep the bank in business. The provisional estimate at end March 2010 of the further capital required by the bank was €18.3 billion.

6.65 In order to provide the capital support, the Minister for Finance issued a promissory note to Anglo Irish Bank in March 2010 with a value of €3.3 billion. In May 2010, the value of the note was increased by €2 billion (to a total value of €10.3 billion). This mechanism will spread the payment out over a number of years. The Minister has indicated that any further capital support for the bank will be provided by the same mechanism.

6.66 At the end of June 2010, a proposal for the provision of a further capital injection of €3.58 billion into Anglo Irish Bank was notified to the EU Commission. This is intended to meet the capital needs of the bank from the end of June to allow it to meet its minimum core tier 1 capital requirements. The capital injection may be increased to a total of €10.05 billion, depending on the accounting treatment of the NAMA bonds in Anglo Irish Bank's accounts. The EU Commission announced temporary authorisation under EU State aid rules for this capital injection on 10 August 2010, pending a final decision on a restructuring plan for the bank.

Acquisition of Building Societies

6.67 Traditionally, Irish building societies concentrated their business focus on providing residential mortgages for customers in Ireland. More recently, INBS in particular (and EBS to a more limited extent) became involved in non-residential lending. In the case of INBS, such lending became its primary focus comprising approximately 80% of its lending business. As a result, they incurred significant losses on speculative lending for land and development and commercial investment loans. In the case of INBS, loan assets with an original value of €9 billion will transfer to NAMA while in the case of EBS, assets with an original value of approximately €1 billion will transfer.

6.68 The estimate at end March 2010 was that INBS required further capital of €2.6 billion to address capital losses arising from the transfer of the first tranche of its property loans to NAMA. The Prudential Capital Assessment Review identified a requirement for the EBS to raise additional equity capital of €875 million.

6.69 In order to avail of State capital support, both building societies passed resolutions allowing them to issue new Special Investment Shares to the State, which paid €200 million from the Exchequer to acquire the shares. As a result of the investment, the State acquired economic ownership of the two societies, and now controls them. The Minister for Finance issued a promissory note to INBS on 31 March 2010, to the value of €2.6 billion.

6.70 Following the planned transfer of assets with an original value of €9 billion to NAMA, INBS will have a small, mainly residential loan book valued at about €2 billion. The Minister announced in his Banking Statement at the end of March 2010 that, in the circumstances, the INBS does not have a future as an independent stand-alone entity. The Government has stated its aim is to secure a swift sale of INBS or its integration with another entity

6.71 The Minister for Finance issued a promissory note to the value of €250 million in respect of the EBS on 17 June 2010. The building society raised a further €8 million through a liability management exercise. Together with the special investment share of €100 million, this contributed a total of €438 million towards meeting the capital requirement of €875 million. The society is currently exploring the availability of private market capital. To the extent that private capital is not forthcoming, the remaining capital requirement will be met either partly or fully through the issue of a further promissory note by the State to the institution.

Delegation of Banking Functions

6.72 In March 2010, the Government delegated a number of banking system functions of the Minister for Finance to the NTMA, to be carried out in accordance with directions issued by the Minister. This delegation related in particular to management of the State's interests in the credit institutions covered by the banking guarantees, negotiation of capital support to those institutions and sustainable development of the banking sector.

6.73 The main functions delegated to the NTMA and the parameters set out in directions of the Minister are

- to lead discussions in consultation with the Department of Finance and the Central Bank and Financial Regulator with the covered credit institutions to determine their likely capital requirements
- to negotiate with the covered institutions the terms and conditions on which any capital support provided by the State will be invested
- to manage any Ministerial shareholdings or other ownership interest in these institutions
- to carry out all of the roles required by the Minister in respect of any relationship framework with any credit institution required under statute
- to lead discussions in consultation with the Department of Finance, with all interested parties on the ultimate shape of the 'third force' and any other restructuring of the financial system
- to conduct on behalf of the Minister any discussions with other players in the market, both national and international, as necessary
- to advise the Minister in relation to his consultations with the Financial Regulator under the Credit Institutions (Financial Support) Scheme and Eligible Liabilities Guarantee Scheme
- to report to the Minister and seek approval and direction prior to making any irrevocable commitment and
- to provide any information required by the Department of Finance in relation to any of the above issues, particularly in the context of discussions with the European Commission on State aid to the banking sector.

6.74 The NTMA has stated that its initial work in the banking area has focused on the analysis of the financial condition of Bank of Ireland and AIB, and the provision of advice to the Department of Finance on specific banking related issues. It has also stated that it negotiated, in consultation with the Department of Finance, with Bank of Ireland and AIB ahead of the Minister's banking statement to the Dáil of 30 March 2010 in which he set out the equity capital requirements of individual institutions and what State support might be provided.

Central Bank Reform

6.75 At the request of the Minister for Finance, the Governor of the Central Bank carried out an examination of the root causes of the systemic failures that led to the need for the extraordinary State support for the Irish banking sector, and of the respective statutory powers, roles and responsibilities of the Central Bank and Financial Regulator in that context. In his report published in May 2010, he identified three primary factors that appeared to have contributed to the problems

- a regulatory approach that was and was perceived to be excessively deferential and accommodating, insufficiently challenging and not persistent enough
- an under-resourced approach to banking supervision that, by relying on governance and risk-management procedures in the regulated institutions, neglected quantitative assessment and the need to ensure sufficient capital to absorb the growing property-related risks
- an unwillingness by the Central Bank and Financial Regulator to sufficiently take on board the real risk of a looming problem and to act with sufficient decision and force to head it off in time.

6.76 The Central Bank Reform Act 2010 was signed into law on 17 July 2010. This provides for a fully-integrated structure — the Central Bank of Ireland — to replace the existing dual-structured Central Bank and Financial Services Authority of Ireland. The Bank will have a unitary Board, ‘the Central Bank Commission’, which will be chaired by the Governor, with a specific focus on regulatory performance, including the development of performance benchmarks. The Bank will be responsible for maintaining the stability of the financial system, the effective regulation of financial institutions and markets and safeguarding the interests of consumers and investors. It will relinquish the current statutory function of promoting the development within the State of the financial services industry.

6.77 The Central Bank Reform Act 2010 includes provisions that will give the Bank specific powers to ensure the fitness and probity of nominees to key positions within financial institutions. It also provides for mechanisms to enhance the accountability of the Bank and oversight by the Oireachtas of its regulatory performance, including

- preparation by the Bank of an annual performance statement in relation to its regulatory functions, to be presented to the Minister and laid before the Houses of the Oireachtas
- international peer reviews of regulatory performance prepared at least every four years (incorporated in the annual performance report of the relevant year)
- provision for a committee of the Oireachtas to call the Governor and/or the Heads of Regulation and of Central Banking to be examined on the annual performance report.

6.78 A further Bill is to be published in the autumn which will set out enhanced regulatory powers and functions for the restructured Central Bank. A third Bill will consolidate all existing statutory provisions.

Administrative Costs of Banking Initiatives

6.79 In the course of developing and implementing the wide range of measures aimed at stabilising the banking sector, there has necessarily been very significant recourse to the services of legal, financial and economic advisors by the Department of Finance, the National Treasury Management Agency and the Central Bank. This was required because of the highly technical issues that have arisen, and because of the frequent need to complete the work within a very short timeframe. The nature and urgency of the work also necessarily resulted in the procurement of some services without recourse to competitive processes. Significant internal costs in relation to staff engaged in the design and implementation of the stabilisation measures have also been incurred.

6.80 The main consultancy contracts entered into by State bodies in relation to banking stabilisation measures are

- **Department of Finance** — contracts with Arthur Cox Solicitors for legal advice and with PricewaterhouseCoopers for accounting advice
- **National Treasury Management Agency (NTMA)** — contracts with Merrill Lynch and Rothschild for advice on financial market issues
- **National Pension Reserve Fund Commission (NPRFC)** — contracts with Arthur Cox Solicitors and PricewaterhouseCoopers for assistance with legal and financial due diligence processes in relation to investment in Bank of Ireland and AIB, and with Sir Andrew Large⁴¹ who was engaged as a ‘trusted advisor’ to assist in overseeing that process
- **Central Bank and Financial Regulator** — commissioned a range of financial consultancy services in relation to the Banking Guarantee Scheme from KPMG, PricewaterhouseCoopers, Jones Lang LaSalle, Deloitte and Ernst & Young.

6.81 Expenditure by the various agencies on consultancy services up to the end of July 2010 amounted to €33.76 million (see Figure 28). It should be noted that this expenditure excludes the costs of consultancy services commissioned by financial institutions at the direction of the Department and/or the Central Bank and Financial Regulator under provisions of the Banking Guarantee Scheme. In those cases, the consultancy costs were paid by the credit institutions themselves.

⁴¹ Sir Andrew Large is a former Deputy Governor of the Bank of England and a former Chairman of the UK Financial Services Authority.

Figure 28 Cumulative expenditure by State agencies on consultancy services for banking stabilisation measures, to end July 2010^a

Commissioning Agency	Consultancy provider	Expenditure to 31 July 2010	
		€m	€m
Department of Finance	Arthur Cox Solicitors	9.66	
	PricewaterhouseCoopers	0.12	9.78
NTMA	Merrill Lynch	7.33	
	Rothschild	4.54	11.87
NPRFC ^b	Arthur Cox Solicitors	1.95	
	PricewaterhouseCoopers	1.58	
	Sir Andrew Large	0.12	3.65
Central Bank/Financial Regulator	PricewaterhouseCoopers	4.95	
	KPMG	2.01	
	Jones Lang LaSalle	0.84	
	Deloitte	0.42	
	Ernst and Young	0.24	8.46
Total for all consultancies			33.76

Source: Department of Finance

Notes:

a Consultants hired in relation to NAMA are dealt with in Special Report 76.

b NPRFC expenditure is to end December 2009.

6.82 Of the consultancy services listed in Figure , three were procured without competitive tender in 2009 by the NTMA as part of the due diligence exercise for the directed investment by the NPRFC in Bank of Ireland and AIB, namely PricewaterhouseCoopers, Arthur Cox and Sir Andrew Large. Furthermore, as these contracts and the contracts for banking advice for Merrill Lynch and Rothschilds were fixed fee arrangements, there was no detailed vouching relating the charges to specific activities. In response to my queries, the Accounting Officer of the NTMA explained that time was of the essence with regard to the due diligence exercise and, given the urgency of the situation, did not allow the Agency to go through the standard public procurement procedures in awarding the contracts.

- PricewaterhouseCoopers and Arthur Cox were engaged to carry out the due diligence as these firms had already been engaged by the Financial Regulator to carry out in depth studies of the banks' asset book in the context of the government guarantee scheme. To have engaged alternative firms would have involved significant delays in order to gather this information once again.
- Sir Andrew Large was engaged as a 'trusted advisor' on certain aspects of the due diligence process including the judgments to be made in light of the final reports because of his specialist expertise in the banking area.

Recovery of Administrative Costs

6.83 To date, the Department has received payments amounting to around €3.3 million from the credit institutions covered by the original Banking Guarantee Scheme in respect of recoupable costs. This total includes €1.7 million in respect of the associated legal expenses. The Central Bank/Financial Regulator also levied fees totalling €6.8 million on the relevant institutions up to the end of December 2009.

Conclusion

Up to the end of July 2010, the State had spent or committed a total of €24.35 billion on the direct provision of financial support to credit institutions. This comprises

- €7 billion invested by the National Pension Reserve Fund in AIB and Bank of Ireland, in return for which it has become a substantial shareholder
- €4.2 billion spent supporting Anglo Irish Bank and taking the INBS and the EBS into State ownership
- the issuing of promissory notes to the value of €10.3 billion to Anglo Irish Bank, €2.6 billion to the INBS and €250 million to the EBS — this mechanism will spread the Exchequer cash payments over a number of years into the future.
- In addition, the Minister for Finance has indicated an intention to provide up to €10 billion in further support for Anglo Irish Bank and up to €37 million for the EBS, if required.

Apart from the capital injections for individual financial institutions, the State has provided substantial guarantees in respect of banking liabilities. At end June 2010, the extent of the credit institutions liabilities covered by such schemes was estimated to be €34 billion. This included €8 billion covered under the Deposit Guarantee Scheme.

The State has received some funding in return for the guarantees it has provided in respect of bank liabilities. By end July 2010, it had collected guarantee fee payments totalling €1,026 million. A small amount of the costs of developing and administering banking stabilisation measures has also been recovered from the institutions availing of the guarantee cover. In addition, substantial balances were held in the Deposit Guarantee Account in the Central Bank (€608 million at the end of 2009).

Administrative costs incurred by State agencies in relation to banking stabilisation measures have been substantial in absolute terms, but are small relative to the scale of the costs, financial commitments and risks associated with the banking stabilisation measures. Access to timely and professional advice is a vital input to decision making in this context. At the same time, it is important to ensure that sound procurement and contracting practices are followed to ensure that the expenses being incurred are no more than is warranted in the circumstances.

